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LITIGATION AND RECOUPMENT OF EXECUTIVE COMPENSATION

*Stephanie L. Soondar**

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I. INTRODUCTION

Merrill Lynch (“Merrill”) suffered fourth quarter losses of \$9.8 billion in 2008. Contemporaneous to its \$50 billion federally aided acquisition by Bank of America (“BoFA”), Merrill was given the green light by BoFA to pay as much as \$5.6 billion in incentive compensation. The legal fallout from the acquisition and bonuses has been dramatic by any standard. Separately, Troubled Asset Relief Program (“TARP”) Special Master Kenneth Feinberg has been a constant presence in the media as he ruled throughout the Fall of 2009 on the compensation proposals for the 100 highest paid executives from companies that received significant federal financing. In his December rulings, among other things, Feinberg required the majority of executives’ pay be held for a period of three years, including incentive compensation paid partially in the form of company stock. New York Attorney General Andrew Cuomo released a popular investigative report on the issue in July 2009,¹ and as recently as January 2010 demanded new bonus information from some of the same companies investigated. Such populist rhetoric and the ongoing economic crisis could provoke shareholders and creditors to seek recoupment

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1. ANDREW CUOMO, ATTY. GEN., N.Y., NO RHYME OR REASON: THE ‘HEADS I WIN, TAILS YOU LOSE’ BANK BONUS CULTURE, http://www.ag.ny.gov/media_center/2009/july/pdfs/Bonus%20Report%20Final%207.30.09.pdf (July 30, 2009).

of executive compensation. This article functions as a broad overview of the possible state and federal legal authorities that parties may face in such an environment.²

For example, both TARP and the Sarbanes Oxley Act of 2002 ("SOX") contain clawback provisions to recapture executive compensation in cases of misconduct. The Securities and Exchange Act of 1934 is also frequently used, via Section 10b and Rule 10b-5 actions, to recapture executive compensation under circumstances of fraud, although recent allegations have failed to survive motions to dismiss for a variety of reasons. Additionally, the federal Bankruptcy Code may also provide for recovery of executive compensation paid by a debtor corporation.

State authority similarly offers a basis from which litigating parties can find support for their claims and defenses. Delaware offers broad discretion for board of director determination of executive compensation. This discretion, however, is not unlimited, as evidenced in *Valeant Pharmaceuticals*. In New York State a variety of possible basis exist for plaintiffs to state a claim, although Defense counsel will be comforted by the lack of modern precedent, and the recent and substantial Richard Grasso victory. Other jurisdictions, such as Alabama in the matter of *Scrushy*, have taken traditional legal theories and applied them to contemporaneous fact patterns, permitting recoupment.

"The perfect storm" involving recoupment of executive compensation appears to have built and is breaking. Although precedent is a guide, it is unknown how a court influenced by the current social and political environment may interpret the fact intensive inquiries required by the laws discussed in this document. The research presented here seeks to provide a solid foundation from which to further explore or develop these inquiries.

II. FEDERAL AUTHORITY

A. TARP

In the fall of 2008, the U.S. economy faced significant challenges, including a weak housing market, elevated inflation, rising mortgage delinquencies and a weakening labor market.³ Several large banks realized

2. It may or may not surprise the reader that shareholders and creditors are not the only parties pursuing litigation in this context, as the variety of suits includes executives' claims that they were illegally denied bonuses, or were fired for protesting other bonus rewards. Tresa Baldas, *Executive Bonuses Triggering Lawsuits Nationwide*, LAW.COM, ¶ 2, Apr. 6, 2002, <http://www.law.com/jsp/article.jsp?id=1202429689471>. This includes a suit against Citizens Republic Bancorp in Michigan, where the executive claims he was fired for questioning a CEO bonus. *Id.* ¶ 5 (citing *Schwab v. Citizens Republic Bancorp*, No. 09-090916-CZ (Mich. Cir. Ct.)). Another executive sued his employer in California for his bonus, was then fired, and then claims his enforcing his rights lead to his dismissal. *Id.* ¶ 6 (citing *Pautsch v. Centex Corp.*, No. 2:2008cv02360 (E.D. Cal.)). A case was also settled in March 2009 in Connecticut, where a high-level employee filed suit for a bonus not paid. *Id.* ¶ 7 (citing *Edwards v. Edwards Wines*, No. CV-08-5008054-S (Conn. Super. Ct.)).

3. *Turmoil in U.S. Credit Markets, Recent Actions Regarding Gov't Sponsored Entities, Investment*

major losses, particularly on mortgage-related assets, and had difficulty raising new capital to offset the losses.⁴ Financial markets became increasingly stressed, and the broader economy continued to deteriorate.⁵ In response to the financial crisis, Congress sought to strengthen the economy and stabilize the financial system by offering public money to private companies through the Troubled Asset Relief Program ("TARP").⁶ In turn, to help thaw frozen credit markets, the government wanted the private banks who received government money to lend to businesses, consumers and other banks.⁷ As part of these bank bailout packages, Congress and the Treasury Department ("Treasury") imposed restrictions on executive compensation at firms receiving government money.⁸ The restrictions are intended to ensure that government funds are used to further the public interest and not for inappropriate private gain.⁹ In particular, President Barack Obama indicated that he did not want the government to subsidize large payouts to poorly performing bank executives who played a part in endangering the financial system.¹⁰ Treasury indicated that with the ultimate goal of systemic regulatory reform, the government is engaging in a long-term effort to investigate the extent that past executive compensation structures at banks contributed to the financial crisis, and how corporate governance regulation can be improved to better promote long-term economic growth and to prevent future financial crises.¹¹

Banks, and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Housing, and Urban Affrs., 110th Congress (2008) (statement of Ben. S. Bernanke, Chairman, Bd. of Gov'rs of the Fed. Reserve Sys.), available at <http://www.federalreserve.gov/newsevents/testimony/bernanke20080923a1.htm>.

4. *Id.*

5. *Id.*

6. See, e.g., Emergency Economic Stabilization Act of 2008, 12 U.S.C. § 5221 (2008) [hereinafter *EESA*]. EESA, passed in late 2008, established TARP, the \$700 billion financial sector bailout whose initial purpose was to buy up toxic mortgage assets from financial institutions. The Treasury Department abandoned the initial plan and decided that the funds would be used to make direct investments in banks and to shore up consumer credit markets. David Lawder, *U.S. Backs Away from Plan to Buy Bad Assets*, REUTERS, Nov. 12, 2008, available at <http://www.reuters.com/article/idUSTRE4AB7P820081112>

7. Erin Nothwehr, *Emergency Economic Stabilization Act of 2008*, The University of Iowa Center for International Finance and Development, December 2008, available at <http://www.uiowa.edu/ifdebook/issues/bailouts/eesa.shtml>.

8. See, e.g., EESA, *supra* note 6, § 111, as amended by American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001 (2009).

9. Press Release, U.S. Dep't of Treas., No. TG-15, Treasury Announces New Restrictions On Executive Compensation, Feb. 4, 2009, available at <http://www.treasury.gov/press/releases/tg15.htm> [hereinafter Treasury Release].

10. Jonathan Weisman and Joann S. Lublin, *Obama Lays Out Limits on Executive Pay*, WALL ST. J., Feb. 17, 2009, at A1. More generally, President Obama said that executive pay helped lead to a "reckless culture and a quarter-by-quarter mentality that in turn helped to wreak havoc in our financial system." Deborah Solomon and Damian Paletta, *U.S. Eyes Bank Pay Overhaul*, WALL ST. J., May 13, 2009, at A1.

11. See, e.g., Treasury Release, *supra*, note 9. On October 22, 2009, the Federal Reserve Board issued a proposal designed to ensure that banks' incentive compensation policies do not encourage excessive risk taking and do not undermine their safety and soundness. One initiative would apply to 28 large, complex banks, and would entail reviewing each bank's policies for risk-appropriate incentive compensation. The practices of the 28 firms would be assessed in a special "horizontal review." Under the second initiative, supervisors would review compensation practices at smaller banks as part of the regular, risk-focused examination process. These reviews would cover all employees who might materially affect the risk profile of a bank. Press Release, Bd. of Governors of the Fed. Res. Sys., Federal Reserve Issues Proposed Guidance on Incentive Compensation, Oct. 22, 2009, available at <http://www.federalreserve.gov/>

1. *Congress Passes EESA, ARRA; Treasury Issues Interim Final Rule*

Congress authorized the TARP bailout in the Emergency Economic Stabilization Act of 2008 ("EESA"), and section 111 of EESA contains provisions limiting executive pay at TARP recipients.¹² Treasury issued an interim rule in October 2008 pursuant to EESA to provide guidance on EESA's executive compensation and corporate governance provisions.¹³ Treasury issued an additional interim final rule in June 2009 (the "IFR") pursuant to the American Recovery and Reinvestment Act of 2009 ("ARRA," also known as the "stimulus bill"), which amended and restated the EESA executive pay and corporate governance provisions.¹⁴

On February 4, 2009, before the release of the IFR, Treasury issued a set of guidelines limiting executive pay ("Treasury Guidelines").¹⁵ The Treasury Guidelines distinguished between firms participating in any new "generally available capital access program" and firms receiving "exceptional financial assistance."¹⁶ An example of a "generally available capital access program" is the Capital Purchase Program created under TARP;¹⁷ while institutions that negotiate bank-specific agreements with Treasury are deemed to require "exceptional assistance."¹⁸ The companies currently receiving "exceptional assistance" include AIG, Chrysler, GM, GMAC, and Chrysler Financial.¹⁹ At

newsevents/press/bcreg/20091022a.htm.

12. See, e.g., EESA, *supra* note 6, § 111.

13. TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (June 15, 2009) [hereinafter *TARP Standards*]. The IFR complies with the requirement in ARRA that Treasury promulgate standards that implement the ARRA provisions. *Id.* at 28396.

14. TARP Standards, *supra* note 13.

15. See, e.g., Treasury Release, *supra* note 9. As noted in text accompanying note 27, *infra*, the IFR superseded prior guidance regarding executive compensation. However, in his 2009 rulings, the Special Master for TARP Executive Compensation, whose duties are discussed *infra* in text accompanying notes 31–40, cited the Treasury Guidelines in limiting cash salaries to \$500,000 or less, other than in exceptional cases. See Press Release of U.S. Dep't of Treas., No. TG-329, The Special Master for TARP Executive Compensation Issues First Rulings, Oct. 22, 2009, available at <http://www.treasury.gov/press/releases/tg329.htm>; Press Release, U.S. Dept. of Treas., The Special Master for TARP Executive Compensation Rules on Compensation Structures for Certain Executive Officers and Most Highly Compensated Employees 26-100, Dec. 11, 2009, available at <http://www.treasury.gov/press/releases/200912111464313585.htm>.

16. See, e.g., Treasury Release, *supra*, note 9.

17. Generally available capital access programs provide the same terms for all recipients, including limits on the amount each company may receive and specified returns for taxpayers. The goal of these programs is to make sure that the financial system, including smaller community banks, can provide the credit necessary for economic recovery. *Id.* In the last week of December 2009, Treasury announced that it provided the last batch of capital under the Capital Purchase Program to ten small banks. Spanning more than a year, Treasury provided 707 banks with \$204.9 billion in capital through the program. Meena Thiruvengadam, *Treasury Ends TARP Bank Investments*, WALL ST. J., Dec. 31, 2009.

18. See, e.g., Treasury Release, *supra* note 9.

19. AIG receives assistance under the Programs for Systemically Significant Failing Institutions. The others receive assistance under the Automotive Industry Financing Program, <http://www.financialstability.gov/impact/DataTables/additionaltransactions.html>. Both Bank of America and Citigroup at one time received "exceptional assistance," but each has since repaid their TARP funds. On December 9, 2009, Bank of

firms receiving “exceptional assistance,” the Treasury Guidelines would impose a strict cap of \$500,000 in total annual compensation paid to each senior executive except for restricted stock awards.²⁰ The Treasury Guidelines’ framework of strictly capping executive pay was abandoned in the IFR, which, pursuant to ARRA, focuses on limiting bonuses paid to most highly compensated employees.²¹ Under the IFR framework, the primary distinction between firms receiving “exceptional assistance” and those that do not is that the former must submit their compensation payments and structures to the Special Master for TARP Executive Compensation (the “Special Master”) for approval, while the latter may apply to the Special Master for an advisory opinion but are not required to do so.²²

Less than two weeks after the release of the Treasury Guidelines, on February 17, 2009, President Obama signed ARRA into law.²³ ARRA amended and restated section 111 of the EESA, and, for the first time, imposed limitations on bonuses paid to employees of TARP recipients.²⁴ The executive

America repaid the government’s \$45 billion TARP investment. Press Release, U.S. Dep’t of Treas., No. TG-436, Treasury Receives \$45 Billion Payment from Bank of America, Dec. 9, 2009, available at <http://www.treasury.gov/press/releases/tg436.htm>. Citigroup repaid \$20 billion in TARP funds on December 23, 2009. Additionally, Citigroup terminated guarantees from the government to share losses on a pool of \$300 billion of Citigroup assets. Press Release, U.S. Dep’t of Treas., Treasury Receives \$45 Billion in Repayments from Wells Fargo and Citigroup, Dec. 23, 2009, available at <http://www.treasury.gov/press/releases/20091229716198713.htm>.

20. See, e.g., Treasury Release, *supra* note 9. A similar cap would be placed on senior executive pay at firms participating in “generally available capital access programs,” except that it would be waived if the company disclosed senior executive compensation and, if requested, submitted a “say on pay” shareholder resolution.

21. Treasury Secretary Timothy Geithner said that the Obama administration is not interested in “capping pay” or “setting forth precise prescriptions for how companies should set compensation.” Rather, he said, the government wants to restrain pay practices that motivated executives to take excessive risks in pursuit of profit. David Cho, Zachary A. Goldfarb, et al., *U.S. Targets Excessive Pay for Top Executives*, WASH. POST, June 11, 2009.

22. TARP Standards, *supra* note 13.

23. Jeffrey Martin, et al., *The Road Ahead: Executive Compensation Provisions for TARP Recipients Under the American Recovery and Reinvestment Act of 2009* 1 (Grant Thornton LLP White Paper), available at http://www.gt.com/staticfiles/GTCom/files/Industries/FSandFI/FINAL_%20road%20ahead_white%20paper.pdf. In discussing an amendment to the bill that would have taxed bonuses at TARP recipients but was later stripped from the bill, discussed *infra* note 75, Senate Finance Committee Chairman Max Baucus made a stunning admission: “Frankly it was such a rush—we’re talking about the stimulus bill now—to get it passed, I didn’t have time and other conferees didn’t have time to address many of the provisions that were modified significantly. We shouldn’t be here. [The bill taxing bonuses] should have passed, but it didn’t.” Dana Bush & Ted Barrett, *Bonuses Allowed By Stimulus Bill*, CNN, <http://www.cnn.com/2009/POLITICS/03/17/aig.bonuses.congress/index.html>.

ARRA also contains provisions that seek to limit unnecessary risk-taking, require executives to certify that the company has complied with the law and adoption of a policy limiting luxury expenditures. See American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001 (2009) [hereinafter *ARRA*].

24. “TARP Recipient” is defined as “any entity that has received or will receive financial assistance under the financial assistance provided under the TARP.” *Id.* The IFR includes an anti-abuse rule which includes in the definition of TARP recipient any entity related to a TARP recipient whose primary purpose is to evade the IFR. TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,412 §30.1. Even before President Obama signed ARRA into law, the administration indicated that it thought that the bill’s approach to limiting executive pay was stricter than the one it favored, and that it would seek revisions. Barney Frank, the chairman of the House Financial Services Committee, said that administration officials may not like the executive pay provision, but “it is going to be enforced.” *White House Wants to Revise Compensation Part of Stimulus*, ASSOC. PRESS, Feb. 15, 2009.

pay restrictions in ARRA apply to all recipients of TARP funds, including those who received money in the past.²⁵ The ARRA pay restrictions apply during the period in which any obligation arising from the receipt of TARP funds remains outstanding, not including any period during which the government holds only warrants to purchase the TARP recipient's common stock (the "TARP Period").²⁶ The IFR consolidates and supersedes prior rules and guidance regarding executive compensation, and is effective as of June 15, 2009.²⁷ For the period between October 20, 2008, and June 15, 2009, the October 2008 interim rule remains in effect.²⁸ Additionally, to the extent they are not inconsistent with ARRA or the IFR, previous contractual provisions entered into by TARP recipients remain in effect.²⁹

2. *The Office of the Special Master*

The IFR establishes the Office of the Special Master, and Treasury immediately named Kenneth R. Feinberg as the Special Master.³⁰ The Special Master's responsibilities include the interpretation and application of section 111 of EESA and its rules and regulations.³¹ The Special Master's decisions are not subject to appeal.³² For TARP recipients receiving "exceptional assistance," the Special Master must determine whether the compensation payments and compensation structures for the TARP recipient's senior executive officers ("SEO")³³ and the twenty next most highly compensated employees³⁴ may result in payments that are inconsistent with the purposes of

25. MARTIN, *supra* note 23. This is in contrast to the Treasury Guidelines, whose standards were not applied retroactively to existing investments or to programs already announced. *See, e.g.*, Treasury Release, *supra* note 9.

26. ARRA, *supra* note 23, § 7001(a)(5).

27. TARP Standards, *supra* note 13, at 28,423. One exception is that the requirement that TARP recipients provide shareholders with a "say on pay" became effective upon enactment of ARRA. *Id.* at 28,404.

28. *Id.* at 28,404.

29. *Id.* at 28,423.

30. Press Release, U.S. Department of Treasury, Interim Final Rule on TARP Standards for Compensation and Corporate Governance, TG-165, (June 10, 2009), available at <http://www.treas.gov/press/releases/tg165.htm>.

31. TARP Standards, *supra* note 13, at 28,420 §30.16.

32. Deborah Solomon, *Pay Czar Gets Broad Authority Over Executive Compensation*, WALL ST J., Jun. 11, 2009, at A4. A TARP recipient may request that the Special Master reconsider his rulings, but only if the Special Master made a factual error or relevant new information comes to light. TARP Standards, *supra* note 13, at 28,423.

33. Senior executive officers are defined in ARRA as the five highest paid employees, whose compensation must be disclosed under the Securities Exchange Act of 1934. 26 U.S.C. § 7001(a)(5). The IFR includes in the definition of senior executive officer a "named executive officer" under Instruction 1 to Item 402(a)(3) of Regulation S-K who is an employee of the TARP recipient. TARP Standards, *supra* note 13, at 28,411.

34. A "most highly compensated employee" is an employee of a TARP recipient, other than a SEO, whose annual compensation for the last completed fiscal year is determined, pursuant to Item 402(a) of Regulation S-K, to be highest among all employees. A most highly compensated employee need not be an executive officer of the TARP recipient. A former employee who is not employed by the TARP recipient on the first day of the fiscal year for which the determination is being made is not a most highly compensated employee, unless it is reasonably anticipated that the employee will return to employment with the TARP

TARP or contrary to the public interest.³⁵ Additionally, compensation structures for any remaining executive officers and the 100 most highly compensated employees of a TARP recipient receiving “exceptional assistance” must be submitted for review by the Special Master, and the Special Master must determine whether the compensation structures may result in payments that are inconsistent with the purposes of TARP or contrary to the public interest.³⁶ The IFR provides a safe harbor regarding compensation paid to employees of TARP recipients requiring “exceptional assistance” so long as the employee is not an SEO or one of the twenty next most highly paid employees, and the employee’s total annual compensation does not exceed \$500,000, excluding long-term restricted stock. In such cases, the compensation will automatically be deemed appropriate even without prior approval of the Special Master.³⁷

Even at TARP recipients who have not received “exceptional assistance,” the IFR allows such firms or employees of such firms to request an advisory opinion from the Special Master as to whether a compensation structure may result in payments that are inconsistent with the purposes of TARP or contrary to the public interest.³⁸ Additionally, the Special Master is given the power to render advisory opinions at his own initiative as to whether compensation payments or structures at any TARP recipient meet the appropriate standards. If the Special Master renders an adverse opinion, he may negotiate with the TARP recipient and employee for reimbursement to the TARP recipient or the Federal government.³⁹ Whenever the Special Master reviews compensation payments or structures for consistency with the purposes of TARP and conformity with the public interest, the Special Master must apply the following principles: (1) avoidance of incentives to take unnecessary risk, (2) taxpayer return, (3) appropriate allocation among the components of compensation, (4) appropriate portion of performance-based compensation, comparable structures and payments, and (5) employee contribution to TARP recipient value.⁴⁰

On October 22, 2009, the Special Master released his first rulings regarding pay packages for the twenty-five most highly paid employees at firms receiving “exceptional assistance.”⁴¹ Employees at Bank of America and

recipient during the fiscal year. *Id.* at 28,398.

35. *Id.* at 28,420-21, §30.16.

36. *Id.* at 28,421, §30.16.

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.* at 28,422-23, §30.16.

41. Press Release, U.S. Dep’t of Treas., The Special Master for TARP Executive Compensation Issues First Rulings, No. TG-329 (Oct. 22, 2009), available at <http://www.ustreas.gov/press/releases/tg329.htm> [hereinafter *Press Release No. TG-329*]. Before the release of this first round of rulings, it was reported that the Special Master pushed the then chief executive of Bank of America, Ken Lewis, into returning the \$1 million he received to that point in 2009 and foregoing the \$1.5 million in salary he was due for the rest of the year. Lewis was also asked to forfeit his 2009 bonus. Lewis, however, was due at least \$69 million in retirement benefits and unvested stock when he stepped down at the end of 2009. Deborah Solomon & Dan

Citigroup were included in these rulings since the two banks still held TARP funds at the time. By reducing overall compensation, particularly cash compensation, and shifting the bulk of compensation to be paid in the form of long-term company stock, the Special Master purported to align executive pay with long-term value creation and financial stability.⁴² Compared to 2008 levels, affected employees' average total compensation was slashed by more than 50 percent, and cash compensation reduced by more than 90 percent.⁴³ More than 90 percent of affected employees were limited to \$500,000 in cash salary, with exceptions where necessary to retain talent and protect taxpayer interests.⁴⁴ Salaries paid in company stock vest immediately, and may only be sold in one-third installments beginning in 2011, unless TARP is repaid earlier.⁴⁵ The requirement that a majority of salary come in the form of long-term company stock serves to force executives to invest their own funds alongside taxpayers and to align executives' interests with taxpayers' interest.⁴⁶ The Special Master also ruled that incentive compensation must only be paid in the form of long-term restricted stock that requires three years of service and can only be cashed in once TARP is repaid. A company may only pay such incentive compensation if executives attain predetermined performance goals set in consultation with the Special Master, and the company's compensation committee certifies the attainment of the goals.⁴⁷

Fitzpatrick, *Czar Blocks BofA Chief's Pay*, WALL ST. J., Oct. 16, 2009, available at <http://online.wsj.com/article/SB125564137421788337.html>.

42. See Press Release No. TG-329, *supra* note 41.

43. *Id.* According to an analysis by the Wall Street Journal, the Special Master substantially increased base salaries for this group of employees. Base salaries climbed to \$437,896 a year on average compared with \$383,409 previously, an increase of 14 percent. 65 percent of employees had an increase in their base salaries. At Citigroup, the Special Master more than doubled salaries for 13 of the 21 employees subject to the first round of review. Government officials said that the increase in base salaries was a response to complaints from the companies that the Special Master was planning on tying up too much employee compensation for the long term. The companies also expressed concern with their ability to retain key employees. David Enrich and Deborah Solomon, *Pay Czar Increased Base Pay at Firms*, WALL ST. J., Oct. 28, 2009, at C1. Some government officials have urged the Special Master to ease up in his 2010 pay rulings for AIG employees. These officials argue that rulings in 2010 as restrictive as those from 2009 could make it more difficult for AIG to repay its TARP funding because key employees would leave. Deborah Solomon, *AIG's Rescue Bedevils U.S.*, WALL ST. J., Nov. 23, 2009, available at <http://online.wsj.com/article/SB10001424052748703819904574554241356640428.html>.

44. See Press Release No. TG-329, *supra* note 41. The Special Master noted three exceptions where base salaries greater than \$1 million were approved: for the new CEO of AIG and for two employees of Chrysler Financial, which is winding down its operations and cannot grant long-term incentives. *Id.*

45. *Id.*

46. *Id.*

47. *Id.* In mid-2009, Citigroup asked Treasury for permission to pay special bonuses to key members of its energy-trading unit, Phibro. Phibro made hundreds of million of dollars for the bank, and members of the unit, who were paid based on how much revenue they produced, threatened to leave due to government pay restrictions. David Enrich and Ann Davis, *Citi Seeks Approval to Pay Out Bonuses*, WALL ST. J., April 29, 2009 available at <http://online.wsj.com/article/SB124096311194466041.html>. Averting a showdown, Citigroup, in October 2009, agreed to sell Phibro. In his October 22 ruling, the Special Master rejected Citigroup's plan to pay Phibro's chief executive a "significant cash bonus," and ruled that nothing may be paid to the chief executive until the sale of Phibro was complete. See Press Release No. TG-329, *supra* note 41.

On March 23, 2010, the Special Master issued 2010 rulings on pay for the twenty five highest paid executives at the five firms still holding "exceptional assistance." The Special Master reaffirmed the principles announced in his October 2009 rulings, including the requirement that the majority of compensation

While the IFR instructs the Special Master to rule on specific payment proposals for the twenty-five highest paid employees of firms receiving “exceptional assistance,” regarding the twenty-sixth through 100th highest paid employees, the IFR directs the Special Master to rule only on compensation structures.⁴⁸ As a result, for this group of employees, companies and their compensation committees have the flexibility to set individual levels of pay based on individual performance using methods approved by the Special Master.⁴⁹ The Special Master’s rulings concerning the twenty-sixth through 100th highest paid employees, released on December 11, 2009, covered four companies: AIG, Citigroup, GM, and GMAC.⁵⁰ Executive pay at Bank of America is no longer subject to the Special Master’s review because the bank returned its TARP funding on December 9, 2009.⁵¹ Additionally, Chrysler and Chrysler Financial were exempt from review in the December rulings because, with one exception, their pay packages complied with the IFR’s \$500,000 safe harbor provision.⁵² In the December rulings, the Special Master echoed the underlying principles emphasized in the first round: aligning pay with long-term value creation and financial stability rather than short-term gains.⁵³ The Special Master required that the majority of each executive’s pay be held for at least three years, and that at least 50 percent of incentive compensation be paid in the form of company stock that must be held for at least three years.⁵⁴ The Special Master again limited cash salaries to \$500,000, other than in exceptional cases,⁵⁵ and the majority of total compensation must be paid in company stock. Salary paid in the form of stock must be held for at least one year from the date it is earned.⁵⁶ Total incentive compensation will be strictly limited to an aggregate “pool” based on metrics determined by the compensation committee and reviewed by the Special Master. Incentives may only be paid if objective performance measures are achieved. Incentive pay is also subject to a clawback should the results giving rise to the payments prove

be paid in long-term stock, and that incentives may be paid only if objective performance results are achieved. Compared to 2009 levels, the Special Master reduced average total compensation for the specific executives by 15%, and cash compensation by 33%. 82% of affected employees received \$500,000 or less in cash salary, with exceptions when good cause was shown. Press Release, U.S. Dep’t of Treas., Special Master Issues 2010 Rulings for ‘Top 25’ Executives at Firms Receiving Exceptional Taxpayer Assistance and ‘Look Back’ Letter on Review of Pre-Recovery Act Compensation, No. TG-604 (March 23, 2010), available at <http://www.ustreas.gov/press/releases/tg604.htm> [hereinafter *Press Release No. TG-605*].

48. TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. at 28,420-21, §30.16

49. Press Release, U.S. Department of Treasury, The Special Master for TARP Executive Compensation Rules on Compensation Structures for Certain Executive Officers and Most Highly Compensated Employees 26-100, (Dec. 11, 2009), available at http://www.financialstability.gov/latest/tg_12112009.html.

50. *Id.*

51. *Id.* However, Bank of America’s twenty-five highest paid executives remained subject to the Special Master’s October ruling through the end of 2009.

52. *Id.* For details on this safe harbor provision, see *supra* text accompanying note 37.

53. Press Release, U.S. Dep’t of Treas., The Special Master for TARP Executive Compensation Rules on Compensation Structures for Certain Executive Officers and Most Highly Compensated Employees 26-100 (Dec. 11, 2009), available at <http://www.treasury.gov/press/releases/200912111464313585.htm>.

54. *Id.*

55. *Id.* The Special Master noted that companies have identified about twelve exceptional cases.

56. *Id.*

illusory or if an executive engages in misconduct.⁵⁷

3. *Clawback of Improperly Determined Pay*

ARRA requires a TARP recipient to recover or claw back bonuses, retention awards, or incentive compensation paid to an SEO and the next twenty most highly compensated employees based on materially inaccurate statements of earnings, revenues, gains or any other performance metric criteria.⁵⁸ A determination of material inaccuracy depends on the facts and circumstances, but if an employee knowingly provides inaccurate information relating to financial statements or performance metrics, such financial statements or performance metrics are deemed materially inaccurate with respect to that employee.⁵⁹ The IFR requires a TARP recipient to exercise its clawback rights unless the TARP recipient demonstrates that it would be unreasonable to do so.⁶⁰ Additionally, once an employee obtains a legally binding right to a bonus payment, the bonus is deemed to be made.⁶¹

4. *Limitations on Bonus Payments*

The IFR, applying ARRA, prohibits the payment or accrual of any “bonus payment,” defined to encompass “bonus,⁶² retention award,⁶³ or incentive compensation”⁶⁴ to a certain number of employees under a sliding scale tied to the amount of TARP funding the company received.⁶⁵ This bonus payment

57. *Id.*

58. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 § 7001, 123 Stat. 115 (2009).

59. TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 113, 28414 (June 15, 2009) (to be codified at 31 C.F.R. pt. 30).

60. *Id.* An example where it would be unreasonable for a TARP recipient to exercise its clawback rights is if the expense of enforcing its rights exceeds the amount to be recovered.

61. *Id.* It is worth noting the anomaly that due to the restriction on the full vesting of bonuses during the TARP period, discussed *infra* at text accompanying note 70, it is not clear that an employee can obtain a legally binding right to a bonus payment during the TARP period that is potentially subject to the clawback.

62. The IFR defines a bonus as any payment in addition to an amount payable to an employee for services performed at a regular hourly, daily, weekly, monthly or similar periodic rate. Commission compensation is generally not a bonus so long as the commission rate is pre-established and reasonable, and is applied consistently to the sale of substantially similar goods or services. Benefits under a qualified retirement or a broad-based benefit plan, bona fide overtime pay and bona fide expense reimbursements are not considered bonuses. *Id.* at 28,405-06, §30.1.

63. A retention award is generally defined as a payment that is contingent on the completion of a period of future service with the TARP recipient or the completion of a specific project, and is not based on the performance of the employee or value of the TARP recipient. Excluded from the definition is any payment to an employee that is payable periodically for services performed at regular hourly, daily, weekly, monthly, or a similar periodic rate. Also not considered retention awards are payments from a qualified retirement or benefit plan, overtime pay, reasonable expense reimbursement, or amounts accrued under a nonqualified deferred compensation plan. *Id.* at 28,411, §30.1.

64. An incentive compensation plan means an “incentive plan” as defined in Item 402(a)(6)(iii) of Regulation S-K, any plan providing stock or options as defined in Item 402(a)(6)(i) of Regulation S-K, and other equity-based compensation. The term includes a stock option or stock plan, regardless of whether the plans are subject to performance-based vesting. A TARP recipient may, however, pay salary or other permissible payments in the form of stock or stock units. *Id.* at 28,409, §30.1.

65. ARRA, *supra* note 23.

limitation does not apply to bonuses paid or accrued prior to June 15, 2009.⁶⁶ For a company that receives less than \$25 million in TARP funding, only the most highly compensated employee is subject to this limitation.⁶⁷ Companies that receive between \$25 million and \$249.999 million may not make or accrue bonus payments with respect to at least the five most highly paid employees. The CEOs and at least the next ten most highly paid employees are subject to this limitation at institutions which receive between \$250 million and \$499.999 million. Finally, the bonus payment restriction at companies receiving more than \$500 million in TARP funding applies to the CEOs and at least the next twenty highest paid employees.⁶⁸ The IFR includes an anti-abuse rule that recharacterizes certain bonus payments that are intended to bypass the bonus restriction. For example, a bonus that is not permitted to accrue in a given year for a certain employee because he is subject to the bonus restriction, but is paid in the subsequent year when the employee is no longer subject to the bonus restriction, would be prohibited pursuant to the anti-abuse principle.⁶⁹

Payments made in long-term restricted stock are allowed notwithstanding the above limitation on incentive pay so long as the restricted stock does not fully vest during the TARP Period, has a value less than or equal to one-third of the restricted stock recipient's total annual compensation,⁷⁰ and is subject to any other terms and conditions that Treasury deems to be in the public interest.⁷¹ Permissible long-term restricted stock awards include both restricted stock and restricted stock units, which can be settled in stock or cash.⁷² The IFR requires that before long-term restricted stock vests, an employee must provide services to the TARP recipient for at least two years after the date of the grant of the stock.⁷³ Additionally, the IFR provides a schedule under which the stock may become transferable.⁷⁴ A second exception which allows for the payment of bonuses notwithstanding the restriction applies if a written employment contract executed on or before February 11, 2009, requires a bonus payment.⁷⁵ The Treasury Secretary,

66. TARP Standards, *supra* note 13, at 28,404.

67. ARRA, *supra* note 23.

68. *Id.* ARRA grants the Treasury Secretary the discretion, concerning TARP recipients of \$25 million or more, to extend the prohibition on bonus payments to a greater number of employees than required by the text of ARRA. *Id.*

69. TARP Standards, *supra* note 13, at 28,400.

70. For purposes of the long-term restricted stock exception, total annual compensation includes all equity-based compensation only in the year in which it was granted at its total fair market value on the grant date. Therefore, all equity-based compensation granted in fiscal years ending before June 15, 2009 will not be included in annual compensation. *Id.*

71. ARRA, *supra* note 23.

72. TARP Standards, *supra* note 13, at 28,400.

73. Significantly, this limitation does not contain an exception for no fault termination events such as death, disability, or involuntary termination.

74. The IFR generally permits the long-term restricted stock to be transferred in increments of 25 percent for each 25 percent of financial assistance repaid by the TARP recipient. Once the final repayment is made, the remaining stock becomes transferable. *Id.* at 28,401.

75. ARRA, *supra* note 23. This provision had the effect of exempting from ARRA pay restrictions the \$165 million in retention bonuses paid to AIG executives. The ensuing outrage over the bonus payments

however, has the discretion to determine the validity of the employment agreement.⁷⁶ This employment agreement exception applies only if the employee has a legally binding right to the payment under the employment contract.⁷⁷ The IFR adds that if a pre-February 11 employment agreement is amended after February 11 and materially enhances the benefit to the employee, such as a pay increase or an acceleration of vesting conditions, then the benefit will not fall within the employment agreement exception.⁷⁸ Finally, the Special Master may provide an advisory opinion regarding pre-June 15 bonus payments and/or payments made pursuant to a pre-February 11 employment contract to determine whether such payments are consistent with TARP or contrary to the public interest.⁷⁹

5. *Limitations on Severance Pay*

ARRA prohibits a TARP recipient from making a golden parachute

exhibited by lawmakers included some initial confusion as to who inserted this exemption in the bill. At first, the Senate Banking Committee Chairman, Christopher Dodd, who originally introduced the executive pay limits, denied that he included the last-minute exemption. A proposed bipartisan amendment would have taxed bonuses at TARP recipients, but it was stripped from the bill during hurried, closed-door negotiations between the White House and the House of Representatives. Dana Bush and Ted Barrett, *Bonuses Allowed By Stimulus Bill*, CNN, March 18, 2009, <http://www.cnn.com/2009/POLITICS/03/17/aig.bonuses.congress/index.html>. After his initial denial, Senator Dodd acknowledged that he added the exemption, but did so only after the Obama administration pushed for it. Ed Hornick, Ted Barrett, and Kristi Keck, *Dodd: Administration Pushed For Language Protecting Bonuses*, CNN, March 19, 2009, <http://www.cnn.com/2009/POLITICS/03/18/aig.bonuses.congress/>. Representative Barney Frank said that the government, as owner of AIG, should assert its ownership rights, including bringing lawsuits against people who did damage to the company. Alison Vekshin, *AIG's Liddy Acknowledges 'Distasteful' Retention Pay*, BLOOMBERG, March 18, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=anFUui3W_YRI. Citing ARRA's provision allowing the Treasury Secretary to claw back payments "inconsistent with the purpose" of TARP or "otherwise contrary to public interest," discussed *infra* in text accompanying notes 86-87, Secretary Timothy Geithner said that Treasury planned to deduct the cost of the bonuses from the government's upcoming round of cash infusion for AIG and to extract additional penalties from AIG operating funds. Jonathan Weisman, Naftali Bendavid and Deborah Solomon, *Treasury Will Make Grab to Recoup Bonus Funds*, WALL ST. J., March 18, 2009, available at <http://online.wsj.com/article/SB123730459869257121.html>. In response to the populist outcry over the AIG bonuses, the House of Representatives voted overwhelmingly, 328-93, to approve a bill imposing a 90% surtax on bonuses paid to employees with household income of \$250,000 or more at companies that have received at least \$5 billion from the government. It appears, however, that the bill will not be taken up in the Senate in light of the fact that a number of AIG executives returned their bonus payments. Greg Hitt, *Drive to Tax AIG Bonuses Slows*, WALL ST. J., March 25, 2009, available at <http://online.wsj.com/article/SB123794222776332903.html>. In the aftermath of the AIG bonus controversy, it was reported that President Obama would seek "resolution authority" that would allow his administration to abrogate contracts that it can show do not serve the good of newly regulated entities such as AIG. Jonathan Weisman, *Obama Seeks Legal Authority to Stop Future Bonuses*, WALL ST. J., March 19, 2009, available at <http://online.wsj.com/article/SB123739640101373211.html>.

76. ARRA, *supra* note 23, § 7001(b)(3)(D)(iii).

77. To determine whether an employee had a legally binding right to payment, the IFR points to 26 CFR 1.409A-1(b)(i). TARP Standards, *supra* note 13, at 28,416.

78. *Id.*

79. *Id.* at 28,404.

payment to a CEO or any of the next five highest paid employees.⁸⁰ A golden parachute payment is defined as any payment to an CEO for departure from a TARP recipient for any reason, except for payment for services performed or benefits already accrued.⁸¹ The IFR deems payments due to a change in control of the TARP recipient to be golden parachute payments, including the acceleration of vesting due to a departure or change in control.⁸² The present value of all golden parachute payments is treated as paid at the time of the employee's departure or change in control of the TARP recipient.⁸³ Thus, if an CEO terminates employment during the TARP period but does not gain the right to a golden parachute payment until after the TARP period, the payment would be barred because the payment is deemed paid while the TARP recipient was subject to the prohibition on golden parachutes.⁸⁴ The IFR provides that payments are not golden parachute payments if they are from qualified pension or retirement plans, payments due to an employee's death or disability, or certain benefit and deferred compensation plan payments.⁸⁵

6. Other Notable ARRA Provisions

ARRA assigns broad discretion to the Treasury Secretary to review past compensation decisions made at TARP recipients, but the legislation also makes it easier for banks to withdraw from the program. ARRA directs the Treasury Secretary to review past bonus payments, retention awards, and other compensation paid to the twenty five most highly paid employees of a TARP recipient, including payments made before February 17, 2009, to determine whether any payments were inconsistent with the purpose of TARP or otherwise contrary to the public interest.⁸⁶ If such a determination is made, the secretary must negotiate with financial institutions and affected employees for reimbursement of those payments to the federal government.⁸⁷ The IFR delegates these duties to the Special Master.⁸⁸ Additionally, ARRA removes past provisions which required TARP recipients to wait for a certain time

80. ARRA, *supra* note 23, § 7001(b)(3)(C).

81. *Id.* at (a)(2). Whether a payment is for services performed or benefits accrued is determined based on the facts and circumstances. Generally, a payment is considered a payment for services performed or benefits accrued only if the payment would be made regardless of whether the employee departs or the change in control occurs, or if the payment is due upon the departure of the employee, regardless of whether the departure is voluntary or involuntary. TARP Standards, *supra* note 13, at 28,408.

82. *Id.*

83. *Id.* at 28,414, §30.9.

84. *Id.*

85. *Id.* at 28,408-09, §30.1.

86. ARRA, *supra* note 23, § 7001(f).

87. *Id.*

88. TARP Standards, *supra* note 13, at 28420. In March 2010, the Special Master issued a "look back" letter to all 419 firms that received TARP assistance before February 17, 2009, requesting information on compensation paid to the twenty five highest paid executives prior to that date. Pursuant to ARRA and the IFR, the Special Master will review the payments to determine conformity with the public interest standard, and he will negotiate for reimbursement of payments where the standard is not met. Press Release No. TG-604, *supra* note 47.

period and to replace the funds through other sources before repaying the government.⁸⁹ A TARP recipient may repay the government funds at any time so long as the federal banking regulator approves the repayment. After the assistance is repaid, the Treasury Secretary will sell outstanding stock warrants at the current market price.⁹⁰ In fact, in June 2009 the Treasury allowed ten banks to repay \$68 billion in TARP money. These banks included J.P. Morgan Chase, Goldman Sachs and Morgan Stanley.⁹¹ Subsequently, in December 2009, Bank of America, Citigroup, and Wells Fargo repaid their TARP funds.⁹²

ARRA requires that shareholders of institutions that have or will receive TARP money be given a non-binding "say on pay" advisory vote to approve the compensation of executives.⁹³ In its annual meeting proxy statement, a TARP recipient must disclose its executive compensation pursuant to the SEC's compensation disclosure rules, including the compensation discussion and analysis, compensation tables and the associated narrative. Shareholders then may vote, by resolution contained in the proxy statement, to approve or disapprove of the company's executive compensation. The shareholder vote is not binding on the Board of Directors, and does not overrule any Board decision.⁹⁴ In the area of corporate governance, ARRA requires each TARP recipient to establish a compensation committee made up entirely of independent directors to review employee compensation plans.⁹⁵ The compensation committee must meet at least semiannually and assess any risk posed to the company from the compensation plans.⁹⁶

89. SHERYL VANDER BAAN & KEVIN F. POWERS, CROWE HORTWATH INT'L, DEVELOPMENTS IN TARP EXECUTIVE COMPENSATION RESTRICTIONS (Feb. 23, 2009), <https://www.crowehorwath.com/Crowe/Publications/detail.cfm?id=2041>.

90. ARRA, *supra* note 23, § 7001(g).

91. The other banks given permission in June 2009 to return government money were U.S. Bancorp, BB&T, American Express, Capital One Financial, Bank of New York Mellon, State Street and Northern Trust. Robin Sidel and Deborah Solomon, *Treasury Lets 10 Banks Repay \$68 Billion in Bailout Cash*, WALL ST. J., June 10, 2009, available at <http://online.wsj.com/article/SB124455528999797923.html>.

92. Bank of America returned \$45 billion, Citigroup repaid \$20 billion, and Wells Fargo \$25 billion. Matthias Rieker, *Citi, Wells Repay TARP Funds*, WALL ST. J., Dec. 24, 2009, <http://online.wsj.com/article/SB10001424052748704254604574614082322331944.html>.

Starting in 2010, Citigroup was no longer subject to the Special Master's review, but it will continue to be subject to the ARRA pay restrictions until the government sells its entire ownership stake. Eric Dash and Andrew Martin, *Wells Fargo to Repay U.S., a Coda to the Bailout Era*, N.Y. TIMES, Dec. 14, 2009, <http://www.nytimes.com/2009/12/15/business/economy/15bank.html?scp=1&sq=Wells%20Fargo%20to%20Repay%20U.S.,%20a%20Coda%20to%20the%20Bailout%20Era&st=cse>.

93. The SEC leadership has indicated that it supports the adoption of "say on pay" for all companies, even those not subject to ARRA. Mary Schapiro, chairman of the SEC, said "giving shareholders a greater say on . . . how company executives are paid" is on the SEC's agenda. BEVERLY FANGER CHASE, NING CHIU, ET AL., DAVIS POLK WARDELL LLP, "SAY ON PAY" NOW A REALITY FOR TARP PARTICIPANTS (Feb. 25, 2009), <http://www.dpw.com/1485409/clientmemos/2009/02.25.09.say.on.pay.pdf>. Compensation experts expect Congress to pass a law requiring all listed companies to adopt "say on pay." Opponents of "say on pay" argue that the practice is vague and ineffective. It is unclear what a "no" vote means and companies are free to ignore the voting results. Phred Dvorak, *Hundreds of Firms Must Grant 'Say on Pay'*, WALL ST. J., Feb. 27, 2009, <http://online.wsj.com/article/SB123569317570788185.html>.

94. ARRA, *supra* note 23, § 7001(e).

95. *Id.* § 7001(c).

96. *Id.*

7. *Consequences of Government Regulation of Executive Pay*

While the pay restrictions outlined above were intended to prevent companies from paying out rewards, subsidized by U.S. taxpayers, to poorly-performing executives,⁹⁷ the restrictions may result in unintended consequences. For one, to comply with ARRA's limitations on the use of incentive compensation, banks may be forced to raise salaries, a development which corporate governance reformers oppose. Big banks typically pay their executives a small salary, but offer large bonuses tied to organizational, division, and individual performance.⁹⁸ This practice, known as pay for performance, serves to align an executive's desire for high pay with shareholders' interest in increased company value. However, with the restriction on bonuses, banks might need to raise salaries to retain and recruit executives, and such salaries will have to be paid no matter how poorly the company performs.⁹⁹ In short, with incentive compensation restricted, an executive's incentive for guiding his company to reach its performance benchmarks is diminished. Supporting the prediction that TARP recipients would raise salaries, a report stated that Citigroup was planning on boosting salaries for certain rank and file employees by as much as 50 percent to offset smaller bonuses.¹⁰⁰

Other unintended negative consequences resulting from the pay restrictions on TARP recipients include the possibility that firms might rush to repay the government even before they are sufficiently capitalized, and some, particularly those subject to the Special Master's review, might have difficulty hiring and retaining senior executives. The government's rationale for extending financing to private banks was to shore up the balance sheets of weak banks, to increase lending activity and to build up confidence, in particular, in the financial system and in the economy in general.¹⁰¹ However, if TARP recipients view the restrictions as too onerous and therefore pressure the banking regulators to allow them to return the funding, these banks might

97. President Obama said, "This is America. We don't disparage wealth. We don't begrudge anybody for achieving success. And we believe success should be rewarded. But what gets people upset—and rightfully so—are executives being rewarded for failure, especially when those rewards are subsidized by U.S. taxpayers." Jonathan Weisman and Joann S. Lublin, *Obama Lays Out Limits on Executive Pay*, WALL ST. J., Feb. 17, 2009, available at <http://online.wsj.com/article/SB123375514020647787.html>.

98. Mark Maremont and Joann S. Lublin, *Limits on Pay Left Unclear in New Law*, WALL ST. J., Feb. 18, 2009, at A4.

99. *Id.* A senior executive responsible for human resources at an investment bank, regarding the limit on bonuses said, "[t]o be put in a situation where you're limiting performance-based compensation is the dumbest thing you can do. Everything that shareholder advocates have been seeking for years is thrown out the window." *Id.*

100. Eric Dash, *Citigroup Is Said to Be Raising Pay*, N.Y. TIMES, June 24, 2009, at B1. Another bank, Wells Fargo, increased the base salaries of its CEO and two other executives in early 2009. Kate Kelly and David Enrich, *Wall Street Pursues Pay Loopholes*, WALL ST. J., March 17, 2009.

101. Erin Nothwehr, *Emergency Economic Stabilization Act of 2008*, UNIV. OF IOWA CENTER FOR INT'L FIN. & DEV., Dec. 2008, <http://www.uiowa.edu/ifdebok/issues/bailouts/eesa.shtml>.

still be at risk of failure even after returning TARP money.¹⁰² In fact, TARP recipients now have further incentive to push for permission to repay the government because now that numerous banks have been allowed to return their money, the market might perceive those that continue to hold government money as relatively weak and unstable. Another problematic consequence of limiting bonuses only at certain banks is that executives at TARP recipients might be tempted to leave for financial institutions not constrained by the pay restrictions, such as private equity funds, subsidiaries of foreign banks or strong U.S. banks which do not hold government funds.¹⁰³ Similarly, a tottering TARP recipient that is integral to the financial system might have difficulty recruiting top executives due to the pay limitations.¹⁰⁴

Clarifying an ambiguity in ARRA, the IFR states that most highly compensated status is determined based on employees' compensation earned in the prior year.¹⁰⁵ However, this provision leaves room for TARP recipients to "intentionally cycle" employees in and out of most highly compensated

102. Some analysts question whether some of the banks that returned TARP funding were allowed by the government to do so prematurely. Some worry that if banks, particularly Citigroup, deplete their capital levels too soon to pay back the government, the banks might stumble again and set the stage for another crisis. Another possible consequence of banks repaying TARP is that extra capital that might otherwise be used for lending is removed from the system. Eric Dash and Jeff Zeleny, *Citigroup Has Reached a Deal to Repay U.S. Bailout Funds*, N.Y. TIMES, Dec. 14, 2009.

103. Thorold Barker, *Capping the Banks' Wages of Sin*, WALL ST. J., Feb. 6, 2009, at C10. In fact, the *New York Times* reported in early 2009 that a brain drain was occurring at some of the biggest Wall Street banks. Top bankers left Goldman Sachs, Morgan Stanley, Citigroup and others to join foreign banks, smaller start-up companies and hedge funds which do not face pay caps. A professor of finance at New York University indicated that there is a positive element to the exodus from large banks. By spreading risk to smaller institutions, there is no longer a systemic threat; and innovation is spread as well. Graham Bowley & Louise Story, *Crisis Altering Wall St. as Starts Begin to Scatter*, N.Y. TIMES, April 12, 2009, at A1. With the Special Master's October 2009 rulings, it became known that about a quarter of the top twenty five executives at the seven firms receiving "exceptional assistance" left their respective companies between June 2009 and the end of the year. Of the potential 175 employees subject to his review, the Special Master, due to the departures, ruled on just 136 pay packages. Only fourteen of the twenty-five highest paid Bank of America employees remained by the time of the Special Master's October rulings. At AIG, thirteen of the top twenty-five remained. Tomoe Murakami Tse & Brady Dennis, *Top Employees Leave Financial Firms Ahead of Pay Cuts*, WASH. POST, Oct. 23, 2009.

104. The pay restrictions compounded the challenges Bank of America faced in hiring a new chief executive following Ken Lewis's announcement that he was retiring. Some analysts suggested that potential candidates for the chief executive job turned it down because of the pay restrictions. With the repayment of its TARP funding, Bank of America was freed from the rules limiting pay. A company spokesman remarked that repayment makes the company more attractive to a CEO candidate. *Bank of America to Repay TARP, Raise Cash*, ASSOC. PRESS, Dec. 2, 2009. Bank of America ended up hiring an internal candidate as CEO, but only after the Special Master indicated that the total pay package sought by an external candidate might cause alarm and be seen as excessive. According to a *Wall Street Journal* report, even though Bank of America executives were no longer subject to the Special Master's review, the company asked Feinberg for his views on a \$35 million to 40 million pay package for an outside candidate. Feinberg said he would have rejected the pay package if he still had the power to do so. His comments contributed to the directors' shift towards hiring the internal candidate. Dan Fitzpatrick & Deborah Solomon, *Last Days of BofA's Hunt for a CEO: Pay, Politics*, WALL ST. J., Dec. 17, 2009. An additional concern of some bank executives as a result of government involvement in the banking system is the politicization of lending. Said Kelly King, chief executive of BB&T Corporation, "Rational, objective lending is one of the most important purposes of the banking system, and when you inject Congress and the administration into it, it effectively politicizes the process, which is not healthy." *3 Banks Plan to Raise Cash to Repay Government*, REUTERS, May 11, 2009.

105. Federal Register, Vol. 74, No. 113, June 15, 2009, 28398.

employee status in alternate years.¹⁰⁶ To illustrate, pursuant to the IFR, a firm receiving more than \$500 million in TARP funds must impose the bonus restriction in 2009 on the twenty-five highest paid employees of 2008.¹⁰⁷ Due to the pay restriction, the twenty-five highest paid employees are unlikely to be the highest paid in 2009, and thus a different group of twenty-five would be the highest paid in 2009. Moreover, in the following year the 2009 highly paid employees would not be allowed to earn bonuses in 2010. The bonus restriction would thus be lifted from the original group who earned the most money in 2008 so that they could earn bonuses in 2010. This might result, intentionally or unintentionally, in groups of twenty-five employees trading places as highest paid every year.

The preamble to the IFR contemplates the possibility of cycling the twenty-five highest paid employees and proposes potential methods to mitigate abuse. One suggestion the IFR proposed is to determine most highly compensated status based on an average of the preceding two or three years' annual compensation.¹⁰⁸ Another approach is to require most highly compensated employees identified for one year to remain subject to the restrictions for a certain number of additional years.¹⁰⁹ The Treasury invites comment on the issue, including the extent to which intentional cycling is likely to occur and how to address the issue.¹¹⁰

8. *Other Re-Regulatory Efforts*

In addition to the Treasury Department's efforts under TARP and the Special Master's office, other federal¹¹¹ actors are instituting new compensation rules for publicly-held corporations and various types of financial service firms. Some of the more significant efforts are discussed here.

9. *The United States Congress*

House of Representatives Member Barney Frank (D-Mass.) introduced¹¹²

106. *Id.*

107. *Id.* at 28,399.

108. *Id.* at 28,398.

109. *Id.*

110. *Id.*

111. The United States is not the only government who is re-regulating the matter of executive compensation. Out of interest and provided as only one example, the British Chancellor of the Exchequer Alistair Darling announced in December 2009 that his office would assess a one-time 50 percent tax on banker bonuses equal to or greater than \$40,700. Ian Katz, *U.S. Probably Will Avoid Matching U.K. 50% Bonus Tax*, BLOOMBERG, Dec. 9, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aVvu7PkQtUsk&pos=3>. In addition, the United Kingdom's Financial Services Authority announced in January 2010 that banking executives and highly compensated employees would have to defer 60 percent of their compensation for a period of three years. Landon Thomas Jr., *U.S. Bankers Are Fed Up With British Regulators*, N.Y. TIMES, Jan. 11, 2010, available at <http://www.nytimes.com/2010/01/11/business/global/11pound.html>.

112. The draft legislation had eleven co-sponsors, including Representatives Capuano (D-Mass.), Carson (D-Ind.), Ellison (D-Minn.), Green (D-Tex.), Gutierrez (D-Ill.), Hinojosa (D-Tex.), Kilroy (D-Ohio), Peters

the Corporate and Financial Institutional Compensation Fairness Act in July 2009 to the House Committee on Financial Services.¹¹³ Shortly thereafter, the draft legislation was successfully voted out of both the Committee¹¹⁴ and the House of Representatives.¹¹⁵ The Act was sent to the Senate and is currently with the Senate Committee on Banking, Housing, and Urban Affairs.¹¹⁶

The Act amends the Securities and Exchange Act of 1934¹¹⁷ to address compensation structures in the context of greater security for the financial system as a whole.¹¹⁸ Among the proposed changes is a nonbinding shareholder advisory vote on executive compensation practices.¹¹⁹ The advisory vote encompasses matters of severance compensation,¹²⁰ and institutional investment managers casting advisory votes are required to disclose how they vote each year.¹²¹ The issue of compensation committee independence is also addressed; committee members are explicitly prohibited from accepting “any consulting, advisory, or other compensatory fee from the issuer.”¹²² A corporation in non-compliance of the new independence rules would face delisting from the national securities exchanges and associations.¹²³ Interestingly, language in the bill directs federal regulators of various types of financial institutions to come together to create new compensation rules and disclosure requirements for incentive-based compensation.¹²⁴ The language is quite clear, however, that no individual’s income will be disclosed;¹²⁵ rather, the legislation seeks to align risk management with pay as a general matter.¹²⁶ In coming together, the federal regulators are further directed to define and

(D-Mich), Sherman (D-Calif.), Waters (D-Calif.), and Watt (D-NC). List of Co-Sponsors, Corporate & Financial Institution Compensation Fairness Act of 2009, H.F. 3269, 110th Cong., LIB. OF CONG., THOMAS DATABASE, <http://thomas.loc.gov/cgi-bin/bdquery/z?d111:HR03269:@@@P>.

113. OpenCongress, *H.R.3269 – Corporate and Financial Institution Compensation Fairness Act of 2009*, “Actions and Votes”, <http://www.opencongress.org/bill/111-h3269/show> (accessed Jan. 11, 2010).

114. The Committee vote was 40 to 28. *Id.*

115. The House Floor vote was 237 to 185. *Id.*

116. *Id.*

117. Corporate & Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 110th Cong. (2009), also available at <http://www.govtrack.us/congress/billtext.xpd?bill=h111-3269> [hereinafter *H.R. 3269*]. Provisions of the act that provide for new federal rule-making regarding what is and is not appropriate incentive pay is enforced under section 505 of the Gramm-Leach-Bliley Act. *Id.* § 4(c).

118. David Brown, Alston & Bird LLP, *Financial Markets Crisis Blog*, “House Passes Executive Compensation Bill,” <http://www.alston.com/financialmarketscrisisblog/blog.aspx?entry=2394> (July 31, 2010).

119. H.R. 3269, *supra* note 117, § 2(i)(1).

120. *Id.* § 2(i)(2)(A-B).

121. *Id.* § 2(i)(3) (where institutional investment managers are subject to section 13(f) of the ‘34 Act).

122. *Id.* §§ 3(a), 10B(b)(2) (where § 3(a) inserts proposed language of § 10B(b)(2)). The independence of paid consultants to the compensation committee will be determined by SEC regulation. *Id.* § 3(a), § 10B(c).

123. *Id.* §§ 3(a), 10B(a)(1).

124. *Id.* § 4(a)(1). Federal regulators included are specified as the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the Securities and Exchange Commission, and the Federal Housing Finance Agency. *Id.* § 4(d)(1)(A)-(G). The legislation also specifies the financial institutions to include depository institutions or depository institution holding companies, broker-dealers, credit unions, investment advisors, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or “any other financial institution that the appropriate Federal regulators” determine is appropriate. *Id.* § 4(d)(2)(A)-(G).

125. *Id.* § 4(a)(2).

126. *Id.* § 4(a)(1)(A)-(C).

prohibit any incentive-pay that “encourages inappropriate risks by . . . financial institutions that could threaten [the] safety and soundness . . . or have serious adverse effects on economic conditions or financial stability.”¹²⁷

10. *The Federal Reserve*

In the Fall of 2009, the Federal Reserve (“the Fed”) issued Proposed Guidance on Sound Incentive Compensation Policies.¹²⁸ The Fed is able to issue such “guidance” under its supervisory authority granted by the Federal Deposit Insurance Act.¹²⁹ The Fed has clearly communicated its expectation that banking organizations will come into immediate compliance,¹³⁰ and has threatened to adjust a bank’s supervisory rating or pursue enforcement action should a deficiency be identified.¹³¹

The guidance is structured to prevent incentive compensation that threatens the stability of the organization itself and the larger financial banking system.¹³² The guidance is applicable to all banking organizations supervised by the Fed.¹³³ Further, the guidance is applicable to both executive employees and individual or groups of employees whose activity exposes the banking organization to risk.¹³⁴ However, the guidance does not mandate pay caps.¹³⁵ Rather, the guidance proposes three broad principles that banking organizations may independently determine how to accommodate.¹³⁶ The principles focus on creating incentive packages that encourage employees to risk-take: within an organization’s ability to identify and manage risk, in ways compatible with effective control and management, and in ways supported by internal governance structures.¹³⁷ In an effort to urge the American banking industry towards compliance, and as a means of identifying best practices, the Fed has initiated a supervisory program to monitor the industry’s progress.¹³⁸

127. *Id.* § 4(b)(1)-(2).

128. Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg. 55,227 (Oct. 27, 2009), available at <http://edocket.access.gpo.gov/2009/pdf/E9-25766.pdf> [hereinafter *Fed. Reg.* 55,227].

129. Posting of Laura Thatcher to Financial Markets Crisis Blog (citing Federal Deposit Insurance Act, 12 U.S.C. § 1818), <http://www.alston.com/financialmarketscrisisblog/blog.aspx?entry=2716> (Oct. 22 2009, 18:56 ET).

130. Fed. Reg. 55,227, *supra* note 128, at 55,227, 55,229, and 55,231.

131. *Id.* at 55,229, 55,232. See also Press Release, Fed. Reserve, Proposed Incentive Compensation Guidance Questions and Answers (Oct. 22, 2009), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20091022a2.pdf> (accessed Jan. 11, 2010) [hereinafter *Fed. Reserve Press Release Oct. 22*]. Where appropriate, the Fed will allow a banking organization to develop a corrective action plan to remedy the deficiency. Federal Register, *supra* note 128, at 55,230, 55,232.

132. Fed. Reserve Press Release Oct. 22, *supra* note 131.

133. *Id.* ¶ 5 (naming “U.S. bank holding companies, state member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency, or commercial lending company subsidiary in the United States” as entities subject to compensation guidance).

134. Memorandum from Fried Frank, New Federal Reserve Proposed Guidance on Sound Incentive Compensation Policies 1, ¶ 1 (Oct. 27, 2009), available at <http://www.friedfrank.com/siteFiles/Publications/3347EFB5D088F79466A9E6CFC6B038D8.pdf>.

135. Thatcher, *supra* note 129, at “How Will the Oversight be Conducted?”

136. Federal Register, *supra* note 128, at 55,228, 55,231-38.

137. *Id.*

138. *Id.* at 55,229, 55,231.

The program is divided between large complex banking organizations (“LCBO”) and smaller, more localized banking organizations.¹³⁹ An LCBO will be expected to offer the Fed a detailed description of its current compensation practices, and a plan for remedying weaknesses.¹⁴⁰ On the other hand, smaller banks will have their incentive compensation reviewed as part of their regular risk examination process.¹⁴¹ Both large and small bank organizations will have the Fed’s findings incorporated into their Federal Reserve supervisory ratings.¹⁴²

11. The Securities and Exchange Commission

In December 2009, the Securities and Exchange Commission (“SEC”) voted to amend how publicly traded corporations disclose executive compensation data.¹⁴³ Companies will be required to come into compliance with the new disclosure rules, effective February 28, 2010.¹⁴⁴ Some of the new rules are discussed below.¹⁴⁵

The SEC wants to prevent undue risk-taking, and considers the new disclosures helpful to investors identifying how a company handles and rewards safe or excessive risk-taking.¹⁴⁶ The final rules adopted require a company¹⁴⁷ to disclose its compensation policies regarding all employees where the compensation creates a “reasonably likely” risk of “material adverse” effect on the company.¹⁴⁸ These new disclosure requirements will be made in a separate paragraph in Item 402 of Regulation S-K and not as part of the CD&A.¹⁴⁹ As part of this disclosure, a company will provide a non-exclusive situational list of when a compensation practice is reasonably likely to create a materially adverse risk to the company.¹⁵⁰ The SEC also modified the disclosure requirements for the Summary Compensation and Director

139. *Id.* (the LCBO program is referred to as “horizontal review”).

140. *Id.* (timetables for completion are expected and the Fed has allocated human resources to work with the LCBOs to achieve the guidance goals).

141. *Id.*

142. *Id.* at 55,229, 55,231-32.

143. Securities Law Advisory from Alston & Bird LLP, SEC Adopts Rules Related to Executive Compensation and Corporate Governance Disclosure (Dec. 17, 2009), <http://www.alston.com/files/Publication/ee6c59ae-045d-486b-8fce-71647c8805a8/Presentation/PublicationAttachment/a5a86418-83a8-410e-b175-71786713e1fe/SEC%20Adopts%20Rules%20Exec%20Comp.pdf> (the vote was 4-1 in favor).

144. *Id.*

145. Regarding executive compensation, the amendments also discuss new rules designed to better communicate potential conflicts of interests to investors as regards compensation consultants. See Proxy Disclosure Enhancements, Securities Act Release No. 9089, Exchange Act Release No. 61,175, Investment Company Act Release No. 29,092, 17 C.F.R. §§ 229, 239, 240, 249, 274, available at <http://www.sec.gov/rules/final/2009/33-9089.pdf> (accessed Jan. 11, 2010). Additionally, the SEC amendments also describe new disclosures regarding director nominees and directors, as well as regards nominee diversity and the board’s leadership structure. *Id.* at 34-40.

146. *Id.* at 9.

147. Smaller companies are anticipated to be exempted from the additional disclosures. *Id.* at 16.

148. *Id.* at 12-13.

149. *Id.* at 13.

150. *Id.* at 14-15.

Compensation Tables, requiring the use of an aggregate grant date fair value for stock and option grants.¹⁵¹

B. SARBANES-OXLEY AND SECTION 304

The Sarbanes Oxley Act of 2002 was the legislative response to the Enron and WorldCom financial scandals of 2000.¹⁵² By enacting SOX, Congress gave the SEC a greater tool for enforcement, and afforded aggrieved shareholders a means of recapturing some of their value lost to fraud and mismanagement.¹⁵³ Among these tools is the “clawback” mechanism of Section 304.¹⁵⁴ Broadly speaking, it provides for disgorgement of executive compensation in instances of “misconduct.”¹⁵⁵ Executive compensation here means any incentive or equity-based pay received from the issuer during the twelve months following the misconduct.¹⁵⁶ This does not include salary.¹⁵⁷ Profits earned from the sale of issuer securities during the same twelve-month period are also subject to disgorgement.¹⁵⁸ Though the potential for recoupment under SOX may appear quite broad, § 304 is subject to significant limitations.

1. *Vague Statute Language*

Section 304 allows for recoupment of executive compensation awarded only to a properly named chief executive officer (“CEO”) and chief financial officer (“CFO”).¹⁵⁹ No other corporate employees’ compensation is included in the statutory language.¹⁶⁰ The statute’s language does not explicitly exclude holding the CEO or CFO responsible for the misconduct of other executives and corporate employees, but until recently the SEC was focused on cases that

151. *Id.* at 21-23 (where awards are computed according to FASB ASC Topic 718 and awards for performance are accompanied by footnote disclosure of an award’s maximum value).

152. See generally Scott Harshbarger & Goutam U. Jois, *Looking Back and Looking Forward: Sarbanes-Oxley and the Future of Corporate Governance*, 40 AKRON L. REV. 1, 3 (2007).

153. See generally David B. Pitofsky and Matthew Tulchin, *Limiting, Clawing Back Executive Pay In the Wake of Financial Bailout*, N.Y. L.J., Jan. 28, 2009, at 1, available at <http://www.goodwinprocter.com/~media/32869322B5754960AD1B186DECBD6C58.ashx>.

154. 15 U.S.C.A. § 7243(a) (2009). SOX 304 provides: If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the twelve-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that twelve-month period.

155. Pitofsky and Tulchin, *supra* note 153, at “Existing Legal Options.”

156. JAMES F. REDA, STEWART REIFLER & LAURA G. THATCHER, *COMPENSATION COMMITTEE HANDBOOK* 156 (3d ed. 2007).

157. *Id.*

158. *Id.*

159. Pitofsky and Tulchin, *supra* note 153, at “Existing Legal Options.”

160. *Id.*

involved only CEO and CFO misconduct.¹⁶¹ This was ironic in light of broad consensus that corporate culture and tone—as regards business ethics and aggressiveness—was set by the CEO and CFO, to be followed by other senior management and by employees generally throughout the corporation.¹⁶² In July of 2009, however, the SEC filed a complaint against Maynard Jenkins, CEO of CSK Auto Corporation.¹⁶³ The complaint seeks disgorgement under § 304 of more than \$4 million in bonus and equity compensation.¹⁶⁴ However the complaint does not contain any allegations of securities fraud by Jenkins himself.¹⁶⁵ Rather, the complaint alleges only that the original financial statements were fraudulent, that Jenkins signed them, and that Jenkins was paid \$4 million in various compensation upon publication of the misstated financial statements.¹⁶⁶ The resolution of this complaint is eagerly anticipated, as it potentially broadens CEO and CFO liability to include securities fraud committed by other corporate employees during the CEO's or CFO's tenure.¹⁶⁷

Because the SEC has not adopted enforcement provisions for § 304,¹⁶⁸ courts are left to determine what various terms mean and how to apply them. For example, although the statute punishes “misconduct,” it does not define what that term encompasses.¹⁶⁹ However, the courts have found that it is not enough for “misconduct” to occur, or to even have been known about by the CEO or CFO.¹⁷⁰ Rather, a public financial restatement must be formally filed by the corporation.¹⁷¹

The factual allegations of cases successfully filed under § 304 offer us some guidance as to what “misconduct” means. Section 304 has been alleged successfully in instances of stock option backdating¹⁷² and manipulated profit

161. See generally Nader H. Salehi & Elizabeth A. Marino, *Section 304 of SOX: New Tool for Disgorgement?*, N.Y. L. J., May 22 2008, available at <http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1202421589570>.

162. See generally Harshbarger & Jois, *supra* note 152, at 29.

163. SEC, Lit. Release No. 21149A (July 23, 2009).

164. SEC v. Jenkins, No. 2:09-cv-01510-JWS (D. Ariz. July 22, 2009).

165. *Id.*

166. *Id.* The SEC's formal actions against CSK include a March 2009 civil injunction charging former executives with various securities charges, including fraud. See SEC Release No. 21149A, *supra* note 163, at ¶ 4. In May 2009, the SEC also instituted settled cease-and-desist proceedings against the company for releasing two years of fraudulent financial statements. *Id.* CSK, of course, neither admitted or denied the charges in accepting the settlement. *Id.* See also *In re Intelligroup Sec. Lit.*, 468 F. Supp. 2d 670, 707 (D.N.J. 2007) *complaint dismissed* (concluding SOX certifications alone do not constitute scienter).

167. JORDAN ETH & BRIAN L. LEVIN, MORRISON FOERSTER, SEC RAISES STAKES ON RESTATEMENTS (Aug. 2009), available at <http://www.mofo.com/news/updates/files/15847.html>.

168. MILBANK, TWEED, HADLEY & MCCLOY LLP, NINTH CIRCUIT FINDS NO PRIVATE RIGHT OF ACTION UNDER SECTION 304 OF SARBANES-OXLEY, (Jan. 2009) available at http://www.milbank.com/NR/rdonlyres/09C1C769-7795-4A07-960C-83C23C1A89DB/0/010509_In_re_Digimarc_Corporation_Derivative_Litigation.pdf.

169. *Cf. In re AFC Enterprises, Inc. Derivative Litig.*, 224 F.R.D. 515, 521 (N.D. Ga. 2004).

170. *Teachers' Retirement Sys. of La. v. Hunter*, 477 F.3d 162, 188-89 (4th Cir. 2007).

171. *Id.* at 189.

172. SEC v. McGuire, 2007 SEC LEXIS 2837 (D. Minn. 2007) (Litigation Release No. 20387). See also SEC v. Nicholas III, Civil Action No. SACV 08-00539-CJC (RNBx) (C.D. Cal 2008), *civil proceeding stayed pending completion of criminal proceedings*, 569 F. Supp. 2d 1065 (C.D. Cal. 2008); SEC v. Jasper, Case No. C-07-6122 HRL (N.D. Cal. 2007) *pending*.

margins.¹⁷³ *SEC v. McGuire*¹⁷⁴ involved backdating and was the first settlement with an individual under § 304, totaling a record \$468 million.¹⁷⁵ McGuire was the former CEO and Chairman of the Board at UnitedHealth Group, Inc., and was accused of stock-option backdating.¹⁷⁶ The allegations described a twelve year period where McGuire selectively chose low common stock closing prices, and signed backdated documents falsely indicating that options had been granted on the dates with the lowest price.¹⁷⁷ The false documents lead to UnitedHealth understating its compensation expenses on public financial statements, contrary to existing accounting rules and misleading shareholders.¹⁷⁸ When UnitedHealth restated twelve annual financial statements for the years 1994 through 2005, the errors totaled \$1.526 billion.¹⁷⁹ In *SEC v. Brooks*,¹⁸⁰ a former CEO and Chairman of the Board at DHB Industries was alleged to have overstated inventory values, falsified journal entries, and failed to charge obsolete inventory, thereby manipulating the company's gross profit margin.¹⁸¹ Brooks also allegedly misused corporate money, engaged in insider trading, and ultimately facilitated the delivery of false financial documents to the public.¹⁸² Currently, the case is still pending in the Southern District of Florida.¹⁸³

Other statutory terms not identified by the Legislature or defined by the

173. SEC, Lit. Release No. 20345, *SEC v. David H. Brooks*, Civil Action No. 07-61526-CIV-Altonaga/Turnoff (S.D. Fla. 2007), <http://www.sec.gov/litigation/litreleases/2007/lr20345.htm>.

174. McGuire, 2007 SEC LEXIS 2837.

175. McGuire, 2007 SEC LEXIS 2837 at *4. At the time, the largest settlement in options backdating case. *Id.* at *1. The amount represents \$11 million in ill-gotten gains, \$2 million in prejudgment interest, \$7 million as a penalty, and \$448 million in disgorged cash bonuses and profits made from the exercise and sale of UnitedHealth stock and unexercised UnitedHealth options. *Id.* at *4. In December 2008, the S.E.C. again moved against UnitedHealth, and separately, its General Counsel (who settled his case privately). SEC, Litigation Release No. 20836, <http://www.sec.gov/litigation/litreleases/2008/lr20836.htm> (Dec. 22 2008). Neither case alleged § 304 violations, however. *Id.*

176. McGuire, 2007 SEC LEXIS 2837 at *1. The derivative settlement was \$ 900 million, historically the largest settlement to date among the backdating settlements, rivaled only by the recent Converse and Broadcom settlements. Converse settled in December 2009 for \$ 225 million. Edvard Pettersson, *Converse, Ex-Chief Settle Backdating Case for \$225 Million*, BLOOMBERG, Dec. 18, 2009, http://www.bloomberg.com/apps/news?pid=20601127&sid=aGdnxEpKy_fw (former CEO Jacob Alexander will contribute \$ 60 of the \$ 225 million). An additional \$ 1.35 million of the \$ 225 million will be paid by former General Counsel William Sorin and former CFO David Kreinberg. *Former Converse Execs to Pay \$62M to Settle Suits*, ASSOC. PRESS, Dec. 28, 2009, available at <http://abcnews.go.com/Business/wireStory?id=9435101> (their contribution will in exchange drop a suit against them that was filed by the company). Broadcom reached a \$160 million settlement in December 2009. *Broadcom Agrees to Pay \$160 Million To Settle Securities Suit*, Wall St. J. Law Blog, <http://blogs.wsj.com/law/2009/12/29/broadcom-agrees-to-pay-160-million-to-settle-securities-suit/tab/print/> (Dec. 29, 2009, 17:26 ET).

177. McGuire, 2007 SEC LEXIS 2837 at *2.

178. *Id.* at **2-3 (the fabricated documents were those relied on by outside auditors).

179. *Id.* at *3.

180. Brooks, Civil Action No. 07-61526-CIV-Altonaga/Turnoff (S.D. Fla. filed Oct. 25, 2007).

181. SEC, Lit. Release No. 20345, *supra* note 173 at ¶ 2.

182. *Id.* at ¶ 3.

183. Though DHB Industries did settle the class action and derivative suit against it in the Eastern District Court of New York for \$35,200,000. Stipulation and Agreement of Settlement 9 at 1.30, available at <http://www.techagreements.com/agreement-preview.aspx?search=lawfirm&lawFirmID=197&num=418744&title=DHB%20Industries%20-%20Stipulation%20And%20Agreement%20of%20Settlement> (Nov. 30, 2006) (resolving class action CV 05-4296(JS)(ETB) and derivative action CV 05-4345(JS)(ETB)).

courts include: “required [to prepare]” when discussing when an issuer must restate its financials, and the meaning of “material noncompliance” when discussing misconduct.¹⁸⁴ Also, § 304 does not identify the state of mind the CEO or CFO must have while perpetrating the misconduct.¹⁸⁵ Rather than alleging acts were committed recklessly or with intent, the SEC has alleged fraud in every case.¹⁸⁶ Other minor limitations include: no retroactive money award to the issuer for executive compensation awarded before SOX enactment in 2002,¹⁸⁷ and reimbursement is solely to the issuer and not any individual or collection of shareholders.¹⁸⁸

2. *No Private Right of Action*

Section 304’s most significant limitation is the lack of a private right of action.¹⁸⁹ The statutory language does not explicitly include or exclude a private right of action, but the courts have interpreted the statute to carry none.¹⁹⁰ At the time of authorship, however, only one circuit court has definitively ruled on the matter.¹⁹¹ There is, however, some debate that the legislative intent was to include a private right of action.¹⁹² Some scholars also argue an implied private right of action exists, relying on *Cort’s*¹⁹³ four-factor test.¹⁹⁴ This test enables a court to find a private right of action in a statute that

184. Reda, Reifler & Thatcher, *supra* note 156, at 155 (questioning whether a restatement is “required” under § 304: when a new accounting firm offers advice to the corporation; or, only under the counsel of SEC comments and suggestions). Also not defined by the language of § 304 is when compensation is in fact “received” by the executive, and what time period is to be used when assessing “profits” from the sale of shares (comparing the sale price to the purchase price of the acquisition). *Id.*

185. Salehi & Marino, *supra* note 161, at “SOX 304’s Ambiguities.”

186. *Id.*

187. AFC Enterprises, 224 F.R.D. at 521.

188. *In re Qwest Communs. Int’l, Inc. Sec. Litig.*, 387 F. Supp. 2d 1130, 1150 (D. Colo. Sept. 12, 2005).

189. Diaz v. Davis, (*In re Digimarc Corp. Derivative Litig.*), 549 F.3d 1223, 1233 (9th Cir. 2008). See also *In re Brocade Communs. Sys. Derivative Litig.*, 2009 U.S. Dist. LEXIS 295 at **51-52 (N.D. Cal. Jan. 6, 2009); *In re InfoSonics Corp. Derivative Litig.*, 2007 U.S. Dist. LEXIS 66043 at *24 (S.D. Cal. Sept. 4, 2007); *Mehlenbacher v. Jitaru*, 2005 U.S. Dist. LEXIS 42007 at *33 (M.D. Fla. 2005); *In re Whitehall Jewelers, Inc. S’holder Derivative Litig.*, 2006 U.S. Dist. LEXIS 16635 at *27-28 (N.D. Ill. Feb. 27, 2006); *In re iBasis, Inc., Derivative Litig.*, 532 F. Supp. 2d 214, 223-25 (D. Mass. 2007); *In re BISYS Group Inc. Derivative Action*, 396 F. Supp. 2d 463, 464 (S.D.N.Y. 2005); *In re Diebold Derivative Litig.*, 2008 U.S. Dist. LEXIS 15747 at **5-6 (N.D. Ohio Feb. 29, 2008); *Neer v. Pelino*, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005); *Pedroli ex rel. Microtune, Inc. v. Bartek*, 564 F. Supp. 2d 683, 686 (E.D. Tex. 2008).

190. *Id.*

191. Diaz, 549 F.3d at 1233. See also *Teachers’ Retirement Sys. of La., supra* note 170 (Fourth Circuit Court explicitly states it is not discussing the matter of private right of action under § 304, but that in any event, none exists); *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines*, 534 F.3d 779, 793 (D.C. Cir. 2008) (indicating in dicta that “§ 304 does not create a private right of action”).

192. Salehi & Marino, *supra* note 161, at “SOX 304’s Ambiguities” (discussing the significance of language being dropped from the final bill indicating an exclusive SEC enforcement role under § 304).

193. *Cort v. Ash*, 422 U.S. 66 (1975).

194. Harshbarger and Jois, *supra* note 152, at 30. The *Cort* four factor test is used to determine if an implied private remedy is contained in a federal statute. *Cort*, 422 U.S. at 78. The factors include: whether plaintiff is among the class for whom the statute was passed to protect or help; if there is legislative intent creating or prohibiting a private right of action; whether recognizing a private right of action is consistent with the “underlying purposes” of the statute; and whether the private cause of action sought is actually a matter of state legislation, and inappropriate to recognize in a federal context. *Id.*

does not explicitly contain one, if, *inter alia.*, the plaintiff is among the class protected by the statute.¹⁹⁵ The Court of Appeals for the Ninth Circuit entertained this *Cort* argument in *Diaz*,¹⁹⁶ but still held there was no § 304 private right of action.¹⁹⁷ *Diaz* noted that harm under a federal statute does not automatically give rise to a private right of action.¹⁹⁸ Seeing no explicit statutory language creating such a right, the Court then analyzed the implied right via the *Cort* four-factor test, treating as dispositive: “whether Congress intended to provide the plaintiff with a private right of action.”¹⁹⁹ The Court concluded that Congress had not for several reasons. First, the language of § 304 focuses on the person regulated (the executive) and not the person ultimately protected (the issuer or shareholder).²⁰⁰ Secondly, the Court looked to other sections of SOX for guidance, finding for example, Congress had explicitly made a private right of action available in § 306 for equitable remedy and explicitly unavailable in § 303.²⁰¹ The Court concluded that Congress, therefore, was equally capable of drafting, or excluding, language for a private right of action under § 304.²⁰² The *Diaz* holding has since been followed in the Ninth Circuit.²⁰³

Interestingly, it took nearly five years after the enactment of SOX for a claim to be filed under § 304.²⁰⁴ The limited amount of circuit court opinions regarding a private right of action under § 304 may be an opportunity for aggrieved shareholders to continue to file § 304 actions in district courts. In light of the public outrage over executive compensation and the current economic crisis, an activist district court unrestrained by a contrary opinion from its circuit court may choose to read the statutory language more broadly.

It is somewhat perplexing that academia would suggest modern courts look to *Cort* for guidance, as this factor test has since been changed. In *Sandoval*, the Supreme Court concluded that “statutory intent [] is determinative” as regards the existence of a private right of action. *Alexander v. Sandoval*, 532 U.S. 275, 286 (2001). The Court specifically instructed that any subsequent court’s task is to determine whether the statute, as passed by Congress, “displays an intent to create not just a private right but also a private remedy.” *Id.* Apart from these considerations, courts “may not create [a private right of action].” *Id.* at 291. This has been adopted in the Second Circuit by the Court in both *Olmstead* and *Bellikoff*, as regards provisions of the Investment Company Act of 1940. *Halebian v. Berv*, 2007 U.S. Dist. LEXIS 55326 (S.D.N.Y. 2007) (discussing *Olmstead v. Pruco Life Ins. Co. of New Jersey*, 283 F.3d 429 (2d Cir. 2002); *Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110 (2d Cir. 2007)). The *Olmstead* factor test includes considerations of: whether the statute contains an explicit private right of action; if the statute contains “rights-creating language” for the protected class; whether the statute provides for alternative methods of enforcement; and whether there was a private right of action provided for anywhere else in the statute. *Halebian*, 2007 U.S. Dist. LEXIS 55326 at *40 (citing *Olmstead*, 283 F.3d at 432-434).

195. *Cort*, 422 U.S. at 78.

196. *Diaz*, 549 F.3d 1223.

197. *Id.* at 1232-33.

198. *Id.* at 1229-30 (citing *Touche Rosse & Co. v. Redington*, 422 U.S. 560, 568 (1979)).

199. *Id.* at 1230-31 (citing *Opera Plaza Residential Parcel Homeowners Ass’n v. Hoang*, 376 F.3d 831, 835 (9th Cir. 2004)).

200. *Id.* at 1232 (citing *Alexander v. Sandoval*, 532 U.S. 275, 289 (2001)).

201. *Id.* at 1232-33.

202. *Id.*

203. *In re Brocade Communs. Sys. Derivative Litig.*, 2009 U.S. Dist. LEXIS 295 at *52 (N.D. Cal. Jan. 2009).

204. Salehi & Marino, *supra* note 161, at “Lack of Use of SOX 304” (citing McGuire, 2007 SEC LEXIS 2837).

However, this seems unlikely where district and circuit courts follow *Diaz*, barring shareholders from pursuing a private claim under § 304.²⁰⁵ Therefore shareholders intent on pursuing disgorgement of executive bonuses and profits in a private action must look to alternative law to state a claim.²⁰⁶

C. STOCK OPTION BACKDATING²⁰⁷ AND SECURITIES LAW²⁰⁸

Frequently, corporate compensation includes equity-based stock option grants,²⁰⁹ and is therefore also subject to recoupment. Private rights of action exist under federal securities laws, empowering the shareholder as an individual or derivatively, on behalf of the corporation.

1. *How Stock Option Grants are Backdated*

A stock option grant creates within the recipient executive the right to purchase a specific number of stocks at a specific exercise price on a specific date.²¹⁰ As a matter of corporate governance, options are generally granted “at the money.”²¹¹ This means the exercise price is equal to the current fair market

205. MILBANK, TWEED, HADLEY & MCCLOY LLP, *supra* note 168, at “Conclusion.”

206. *Id.*

207. The breadth of stock option backdating is wide and complex, and warrants its own investigation. It involves securities law, tax law and accounting principles. For purposes of focus and clarity to the topic of this paper, stock option backdating is treated as relevant, but ancillary to the global topic of litigation and executive compensation.

208. The Securities Act of 1933 (“33 Act”) has been cited in some litigation to combat fraud allegations. 15 U.S.C. § 77a (2009); *see generally* SEC v. Reyes, No. 06-CV-3844 (E.D.N.Y. Aug. 9, 2006). The 33 Act focuses almost exclusively on the sale and purchase of securities. *See generally* THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION 326-57 (5th ed. 2005). In contrast, the Securities and Exchange Act of 1934 (“34 Act”) deals more generally in the transacting of securities, as well as the regulation of the market and industry. 15 U.S.C. § 78a (2009); HAZEN, *supra*. So as to retain this paper’s litigation focus, this research document will focus on the 34 Act allegations.

209. STAFF OF JT. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 2 (2006), available at <http://www.house.gov/jct/x-39-06.pdf>. The practice of equity-based compensation, in theory, is to link the executive’s compensation to her performance at the company. M.P. Narayanan, Cindy A. Schipani, & H. Nejat Seyhun, *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 8, 1606 (2007). The harder and smarter she works, the more the corporation benefits, the fair market price of the corporation’s stock rises, and the executive earns more money when her stock options vest in the future. Too, linking the executive’s compensation this way to her performance sometimes ameliorates criticism of excessive executive salary. John D. Shipman, *The Future of Backdating Equity Options in the Wake of SEC Executive Compensation Disclosure Rules*, 85 N.C.L. REV. 1194, 1200 (2007). The practice of backdating, however, dilutes the interests of existing shareholders by increasing the number of outstanding shares. *Id.* at 1200. Equity-based compensation also creates a moral hazard when the vesting period is short, causing the executive to focus on short term growth, and perhaps tempting executives to circumvent existing laws to reap greater profit. *Id.*

210. Frank Ahrens, *Scandal Grows Over Backdating of Options*, “How Does Backdating Work?”, THE WASH. POST, Oct. 12, 2006, http://www.washingtonpost.com/wp-dyn/content/article/2006/10/11/AR2006101100425_pf.html (Oct. 12, 2006).

211. DR. SUNIL PANIKKATH, ET. AL, NERA ECONOMIC CONSULTING, OPTIONS BACKDATING: A PRIMER 7, http://www.nera.com/image/PUB_Backdating_Part_1_Primer_SEC1381_final.pdf (Oct. 5, 2006). There are a number of reasons at-the-money options are typical. First, before the summer of 2005, companies were required to grant options with a strike price “at least equal” to the fair market value of the option. JEFFREY M. TAYLOR, BLANK ROME LLP, UNDERSTANDING THE OPTIONS BACKDATING CONTROVERSY—NEW

price of the stock on the day of the grant.²¹² “In-the-money,” or discounted options, means that the exercise price is lower than the fair market stock price on the day of the grant.²¹³ Backdating describes the act of, either at the time the grant is written or retroactively after the grant is written, changing the grant date to an earlier date so that the exercise price is lower than the fair market stock price on the day of the grant.²¹⁴ This practice creates a gain for the recipient executive, between the low backdated price and the high grant date price.²¹⁵ This practice of backdating is not categorically illegal.²¹⁶ Where the practice is duly-authorized by the board,²¹⁷ fully disclosed, and in compliance with relevant accounting and tax provisions, then backdating is not illegal.²¹⁸ However, as of January 2007, over 200 companies had come under investigation for backdating by either the SEC, the Justice Department, or their own boards.²¹⁹ Backdating came to light in 2006, and to date the ultimate ramifications are not yet fully known.²²⁰

2. Tax²²¹ and Financial Reporting Consequences

The tax and financial reporting consequences of backdating is complex.²²²

DEVELOPMENTS 4 at note 1, <http://www.blankrome.com/siteFiles/News/0583BEE9934239C296F74285849E0AAD.pdf> (2007) (citing Accounting Principles Board Opinion No. 25). Second, in most cases, an option characterized as an “incentive stock option” must be issued as at-the-money or out-of-the-money on the date of the grant. *Id.* (citing I.R.C. § 422 (1986)). Third, public corporations must disclose to the investing public any grant of in-the-money options. *Id.* (citing Item 402(d)(2)(vii) of Regulation S-K, 17 C.F.R. § 229.402(d)(2)(vii)).

212. PANIKKATH, ET AL., *supra* note 211, at 7.

213. Shipman, *supra* note 209, at 1201-1202.

214. COOLEY GODWARD KRONISH LLP, COOLEY ALERTS, STOCK OPTION BACKDATING: THE LATEST “HOT ISSUE” ¶ 4 (June 5, 2006), <http://www.cooley.com/news/alerts.aspx?id=39704820>. It should also be noted that business academics also track and analyze “forward dating.” Narayanan, Schipani, & Seyhun, *supra* note 209, at 1602-03. This is the practice of deferring a grant date in light of a current low stock price that will foreseeably continue to fall in the short-term. *Id.* The option grant is then set on a date when the fair-market price of the stock is at a foreseeable low of lows. *Id.* There is also “spring loading” or bullet dodging,” which respectively means, timing a grant before a public announcement of good news or directly after a public announcement of bad news. Eric Lie, *Backdating of Executive Stock Option Grants (ESO)*, <http://www.biz.uiowa.edu/faculty/eric/backdating.htm> (accessed Mar. 15, 2009).

215. Ahrens, *supra* note 211, at “How Does Backdating Work?”

216. PANIKKATH, ET AL., *supra* note 211, at 9.

217. *Compare* Ryan v. Gifford, 918 A.2d 341, 355-356 (Del. Ch. 2007) (quoting Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984)) (“Backdating options qualifies as one of those rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment.”); *Matter of Tyson Foods Inc. Consol. Shareholder Litig.*, 919 A.2d 563, 592 n. 74 (Del. Ch. 2007); *In re Comverse Technology, Inc., Derivative Litigation* Leonard Sollins, et al. v. Comverse Technology, Inc., 56 A.D.3d 49, 56 (N.Y. App. Div. 1st Dept. 2008).

218. Narayanan, Schipani & Seyhun, *supra* note 209, at 1601-1602.

219. Daniel W. Collins, Guojin Gong & Haidan Li, *Corporate Governance and Backdating of Executive Stock Options* 2 note 1 (2008), <http://ssrn.com/abstract=934881> (citing *Options Scorecard*, WALL ST. J., available at <http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html>).

220. See generally S.E.C., Spotlight on Stock Options Backdatings, <http://www.sec.gov/spotlight/optionsbackdating.htm> (last updated Dec. 11, 2009).

221. *N.B.* This disclosure is made per Treasury Department Circular 230. Any discussion of federal tax issues contained within this document is not advice. This document was written as a means of marketing and research. Any discussion of federal tax issues was not written as advice, and therefore cannot reasonably be used by any person to avoid obligations imposed upon them via the Internal Revenue Code.

For instance, an at-the-money stock option is considered performance-based and therefore does not count towards the corporation's \$1 million dollar executive compensation deduction cap under Internal Revenue Code § 162(m).²²³ However, in-the-money stock options are not considered performance based with regards to the difference between the low exercise price and the higher fair market price of the stock on the day of the grant²²⁴ (referred to as intrinsic value).²²⁵ That difference in price counts towards the \$1 million dollar deduction under § 162(m).²²⁶ Depending on the circumstances of backdating, a corporation may have taken full deductions on amounts that should have been limited.²²⁷

With regards to financial statements which are represented as "GAAP compliant," the corporation must record a compensation expense when in-the-money stock options are granted.²²⁸ The expensed amount is the intrinsic value of the in-the-money options. If this expense was not properly recorded during the financial period it was incurred, a corporation may need to restate financial statements to accurately reflect the compensation expense.²²⁹ Since the accounting of options is recorded over the course of the designated vesting period, a single act of backdating may result in the restatement of several years

222. Although it would be beyond the scope of this document to discuss in greater detail the tax environment surrounding options backdating, some basic information is appropriate. For example, where options are granted as incentive stock options: the exercise of that option by the optionee does not typically result in taxable income. Taylor, *supra* note 211, at 37. This presumes, however, that certain incentive stock option rules are followed, one of which is that the option's exercise price is equal or greater than the fair market value of the stock on the day of the grant. *Id.* Non-compliance would disqualify the option for favorable treatment. *Id.* at 41.

A false or inaccurate tax return can be treated a variety of different ways. Taylor, *supra* note 211 at 39. If the taxpayer—corporation or individual—willfully made a false return, there is possible criminal penalty of up to three years incarceration and a \$100,000 fine for each violation. *Id.* (citing I.R.C. § 7206(1) (West 2002)). Alternatively, if the taxpayer innocently made a false return, the Internal Revenue Service ("IRS") may collect any unpaid taxes, penalties, or interest. *Id.*

223. KAREN FIELD, KPMG, MISDATED AND OTHER DISCOUNTED STOCK OPTIONS 4, http://www.kpmginfo.com/PayrollInsights/downloads/Section409A_Explanation.pdf (2007) (discussing I.R.C. § 162(m) (2007)). There is small debate that this deduction cap of \$1 million can legally be exceeded. See, e.g., Shipman, *supra* note 209 at 1201 n. 42 (citing Eric Lie, *On the Timing of CEO Stock Option Awards*, 51 Mgmt. Sci. 802, 803 (2005)).

224. FIELD, *supra* note 223 at 4.

225. Raquel Meyer Alexander, Mark Hirschev & Susan Scholz, *Backdating Employee Stock Options: Accounting and Legal Implications*, CPA J., Oct. 2007, <http://www.nysscpa.org/cpajournal/2007/1007/infocus/p18.htm>.

226. FIELD, *supra* at 1. The tax effects are more complex. In brief, know that 162(m) also requires that the options be granted by a compensation committee, and by shareholder approval. Narayanan, Schipani & Seyhun, *supra* at 1620-21. Also note there is differing tax treatment under §§ 409(a) and 422 of the Code, for deferred compensation, statutory incentive stock option ("ISO") plans, and non-statutory stock option plans ("NSO"). *Id.*

227. FIELD, *supra* at 1.

228. Narayanan, Schipani & Seyhun, *supra* at 1606. The 34 Act requires a public corporation to maintain its books to accurately reflect that corporation's assets. Taylor, *supra* note 211 at 20-21 (citing 34 Act § 13(b)(2)(A), 15 U.S.C.A. § 78m(b)(2)(A) (West Supp. 2007)). Public corporations are also required to maintain an internal system of accounting and controls to ensure continued accurate reporting of transactions. *Id.* (citing 34 Act § 13(b)(2)(B), 15 U.S.C.A. § 78m(b)(2)(B) (West Supp. 2007)). A public corporation must assess this internal system annually, and disclose any material impact caused, or foreseeably caused, by any changes. *Id.* (citing Exchange Act Rule 13a-15(c), (d), 17 C.F.R. § 240.13a-15(c), (d)).

229. COOLEY GODWARD, *supra* note 214, at "What are the potential ramifications?"

of financial statements.²³⁰ Additionally, corporations must disclose their executive compensation in proxy statements to shareholders.²³¹ If a corporation published that at-the-money options were granted, but as a result of backdating, in-the-money options were in fact granted, those proxy statements would be inaccurate and might be considered fraudulent.²³²

SOX requires corporations to file a Form 4, reporting changes in beneficial ownership of securities to insiders within two days of a transaction.²³³ Since 2002, the possible universe for backdating is two days.²³⁴ Although Form 4s are not always timely filed,²³⁵ a late Form 4 suggests possible backdating.²³⁶ SOX's Form 4 was followed by the "new" Executive Compensation rules released by the SEC in August and December of 2006.²³⁷ Among the several things accomplished by these new rules was the Compensation Discussion and Analysis ("CD&A").²³⁸ The CD&A requires the corporation to articulate in detail the objectives of executive compensation,

230. *Id.*

231. *Corporate Counsel's 2008 GC Compensation Survey* ¶ 2, LAW.COM, Aug. 2008, <http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1202423065928>.

232. COOLEY GODWARD, *supra* note 214, at "What are the potential ramifications?" Federal securities law provides a number of different means for combating fraud in investor and shareholder disclosures. Fraud, in this case, includes materially misleading misstatements in registrations statements (33 Act § 11, 15 U.S.C.A. § 77j (West 2002)), prospectuses (33 Act § 12(a)(2), 15 U.S.C.A. § 77k(a)(2) (West 2002)), securities transactions (e.g. 33 Act § 17(a)(3), 15 U.S.C.A. § 77p(a) (West 2007)), proxy statements (Exchange Act Rule 14a-9(a), 17 C.F.R. § 240.14a-9(a)), SEC reports (34 Act § 18(a), 15 U.S.C.A. § 78r(a) (West 2002)), and public announcements, such as press releases (Exchange Act Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b)). Taylor, *supra* note 211, at 15.

233. *In re Zoran Corp. Derivative Litigation*, 511 F. Supp. 2d 986, 1006 (N.D. Cal. 2007), settlement approved, 2008 U.S. Dist. LEXIS 76623 (N. D. Cal. Sept. 2, 2008) (citing 15 U.S.C. 78p(a)(2)(C)). The 34 Act prohibits insider trading. Taylor, *supra* note 211 at 17. Where a person owes a duty of trust or confidence to the corporation or the corporation's shareholders, and is in possession of material and non-public information, that person must either disclose the information to the person she is trading with, or abstain from trading altogether. *Id.* (citing *Chiarella v. U.S.*, 445 U.S. 222, 233 (1980)). A person is also guilty of insider trading if she has confidential information of another who she owes a duty of loyalty and confidence to, and trades on that information ("misappropriation theory"). *Id.* (citing *U.S. v. O'Hagan*, 521 U.S. 642, 652 (1997)); Exchange Act Rule 10b5-2, 17 C.F.R. § 240.10b5-2.

234. *Id.* at 1006.

235. *Id.*

236. VINSON & ELKINS, OPTIONS BACKDATING UPDATE, V&E SECURITIES LITIGATION E-COMMUNICATION (July 26, 2006), http://web.archive.org/web/20070820052126/www.vinson-elkins.com/resources/resource_detail.asp?rid=322803901&rtype=pub (discussing academic studies which report 10 percent to 21 percent of option grants are untimely filed, suggesting backdating). Other red flags include: a spike in the corporation's stock price immediately after publicly reporting a grant, or the practice of grants by unanimous written consents. COOLEY GODWARD, *supra* note 214 at "What is Backdating?"

237. SEC Staff Interpretation, Item 402 of Regulation S-K—Executive Compensation ¶ 1, <http://www.sec.gov/divisions/corpfin/guidance/execcomp402interp.htm> (last updated Aug. 8, 2007) (discussing Securities Act Release No. 8732A and Securities Act Release No. 8765). The SEC is considering changing, once again, how corporations report executive income, so as to effectuate greater disclosure. CENTER ON EXECUTIVE COMPENSATION, SCHAPIRO SAYS SEC CONSIDERING BROADER PAY DISCLOSURE REQUIREMENTS ¶ 1, (May 1, 2009), <http://www.execcomp.org/news/news-story.aspx?ID=723>.

238. EMERY B. SHEER & DANIELLE K. SHEER, INST. OF INTERNAL AUDITORS, BUSINESS NETWORK, SHEDDING LIGHT ON EXECUTIVE PAY: IN THEIR AUDITS OF COMPENSATION, AUDITORS SHOULD REVIEW THE CONTROLS THAT ENSURE APPROPRIATE DISCLOSURE AS MANDATED BY NEW SEC RULES ¶ 5 (Apr. 2007), available at http://findarticles.com/p/articles/mi_m4153/is_2_64/ai_n19020895 (discussing Item 402(b) or Regulation S-K).

citing specific elements used to arrive at a final compensation package.²³⁹ Also required by the new executive compensation rules is a tabular disclosure requirement.²⁴⁰ This tabular format includes a number of columns that will aid the shareholder in better understanding the value of the option grant at the time it was awarded.²⁴¹ The tabular format includes the date on which the option was awarded and the fair market value of the security on that date.²⁴² Both the CD&A and tabular data must be filed with the SEC, and therefore any statements or representations made within are subject to the liability provisions of the 1933 and 1934 Acts.²⁴³

3. *Backdating and Derivatives Litigation*

*Zoran*²⁴⁴ is an example of how disgruntled shareholders, in derivatives litigation have recaptured some of the value high level executives gained when compensated with stock option grants. *Zoran* involved claims of backdating and false proxy statements.²⁴⁵ After surviving a motion to dismiss, plaintiff settled and the corporation was reimbursed \$3.4 million, and several options were re-priced at an estimated recaptured value of nearly \$2 million.²⁴⁶ The suit alleged against the corporation's CEO and CFO, violations of § 10(b), Rule 10b-5, and § 20(a) of the 1934 Act.²⁴⁷ Section 10(b) and Rule 10b-5 claims involve the existence and use of manipulative and deceptive devices.²⁴⁸ Plaintiff alleged that defendant Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") had misrepresented to the corporation the value of the stock options granted.²⁴⁹ The corporation relied on these

239. *Id.* Item 402 of Regulation S-K, 17 C.F.R. §§ 229.402(b) (2010). This includes, but is not limited to: the policy behind awarding equity compensation as opposed to cash compensation, *id.* § 402(b)(2)(ii); how compensation is designed to award executive performance, *id.* at 402(b)(2)(vii); the affect of the executive compensation on corporate tax and financial reporting matters, *id.* at 402(b)(2)(xii).

240. Shipman, *supra* note 209 at 1207-1208.

241. *Id.*

242. *Id.*

243. Sheer & Sheer, *supra* note at ¶ 5. See also Taylor, *supra* note 211, at 25-26. The principal executive officer and principal financial officer must sign certifications for each annual and quarterly reports. *Id.* (citing 34 Act 13a-14, 17 C.F.R. § 240.13a-14). These certifications attest to, among other things: the accuracy of the financial statements, the proper disclosure of information to auditors, as well as the disclosure of any fraud. *Id.* (citing 18 U.S.C.A. § 1350 (West 2002); Item 601(b)(31) of Regulation S-K, 17 C.F.R. § 229.601(b)(31)).

244. *Zoran*, *supra* note 233.

245. *Id.*

246. *In re Zoran Corporation Derivative Litigation*, 2008 U.S. Dist. LEXIS 76623 at *4 (N.D. Cal. 2008) (court approved settlement).

247. *Zoran*, 511 F. Supp. 2d at 1010-1011.

248. *Id.* (discussing 15 U.S.C.S. § 78j (2008) and 17 C.F.R. 240.10b-5 (2008)). A successful § 10(b) and Rule 10b-5 claim in the Ninth Circuit requires the plaintiff to plead with regard to each defendant:

- (1) that defendants made a material misrepresentation or omission;
- (2) the misrepresentation was in connection with the purchase or sale of a security;
- (3) that the misrepresentation caused plaintiff's loss;
- (4) that plaintiff relied on the misrepresentation or omission;
- (5) that defendants acted with scienter; and
- (6) that plaintiff suffered damages.

Zoran, 511 F. Supp. 2d at 1010-1011

249. *Id.*

misrepresentations in awarding option grants, suffering harm by “parting with its shares at a lower price than was right.”²⁵⁰ The Court found the allegations were successfully plead and refused to dismiss the claim.²⁵¹ The claim for control person liability under § 20(a) was also leveled against the CEO and CFO.²⁵² However, plaintiff failed to successfully plead that the people who committed fraud were under the control of the CEO and CFO, and thus the Court dismissed plaintiff’s claim.²⁵³

4. ‘Essential Link’²⁵⁴ and Proxy Statements

The plaintiff also made a claim under § 14(a) of the 1934 Act against the members of the audit and compensation committees for issuing false proxy statements to the corporation’s shareholders.²⁵⁵ The Court found this claim was properly plead and denied a motion to dismiss.²⁵⁶ Of important note regarding the § 14(a) proxy claim is that the plaintiff properly plead the “essential link” element.²⁵⁷ This has been a problematic element for other

250. *Id.*

251. The court found the elements of the § 10b and Rule 10b-5 claims were satisfactorily plead. *Id.* at 1013. The element of material misstatement or omission was successfully plead as both the CEO and CFO personally administered option grants and knowingly signing false and misleading financial statements and SOX certifications. *Id.* at 1011. As a result of these misstatements, several financial statements were restated, recognizing a “charge of twelve to fifteen million dollars in compensation expenses.” *Id.*

Transactional causation and reliance was successfully plead as all stock options were pre-approved by the CEO before granted, and witnesses indicated that the CFO was “integral [to] every aspect.” *Id.* at 1012. The corporation in turn, then, relied on the representations made to it by its executive officers, and issued shares for prices that were below the fair market price the corporation would have otherwise received. *Id.*

Scienter was successfully plead as not only as the CEO and CFO were “involved” in the granting of backdated options and therefore should have known of the backdating, but that the CEO and CFO gave approval of the option granting process and in fact oversaw the process. *Id.* at 1013. In addition, the CEO and CFO prepared and signed false proxy statements. *Id.* The claim was timely filed under the statute of limitations element, as the action was filed within five years of the violation. *Id.* at 1013-1014.

252. *Id.* at 1015 (discussing 15 U.S.C. § 78t (2008)). In the Ninth Circuit, “plaintiff must allege that: (1) there was a primary violation of the securities laws; and (2) that the defendant exercised actual power or control over the violator.” *Id.* Compare Take-Two 20(a) element test, *infra* note 275.

253. In the Ninth Circuit, plaintiff must first successfully plead a violation of securities law, and then successfully plead the defendant had “control over the violator.” Zoran, *supra* note 233.

254. *Id.* at 1016.

255. *Id.* See Belova v. Sharp, 2008 U.S. Dist. LEXIS 19880 at *20 (D. Or. 2008) (successfully plead the “essential link” element in a 14(a) allegation). Compare Engel v. Sexton, 2009 U.S. Dist. LEXIS 12778 (E.D. La. 2009) (14(a) complaint dismissed); In re Marsh & McLennan Cos. Sec. Litig., 536 F. Supp. 2d 313 (S.D.N.Y. 2007) (14(a) complaint dismissed without prejudice). To plead a claim under [§] 14(a) in the Ninth Circuit, plaintiff must allege that:

- (1) defendants made a material misrepresentation or omission in a proxy statement;
- (2) with the requisite state of mind; and
- (3) that the proxy statement was the transactional cause of harm of which the plaintiff complains.

Zoran, *supra* note 233, at 1015 (interpreting 34 Act, 15 U.S.C. 78n(a) (2008)).

256. *Id.* at 1016. The element of misstatement and state of mind was successfully plead as plaintiff indicated a reasonable shareholder would consider self-dealing material in regards to voting, and that the proxy statements for an eight-year period misstated not only option grant dates, compensations expenses, and financial results, but also falsely stated the board was compliant with the shareholder approved stock option plans. *Id.* at 1015. The statute of limitations element was successfully plead as to proxy statements issued between years 2003 and 2005, as they fall within the three-year statute of repose. *Id.* at 1017.

257. *Id.* at 1016.

plaintiffs to satisfy.²⁵⁸ Plaintiff had to show that the proxy solicitation itself, and not the fraud contained within it, was the cause of the injury to the corporation.²⁵⁹ *Zoran's* plaintiff survived this standard by pleading that the board used the proxy statements to maintain their positions and continue the backdating practice.²⁶⁰ The shareholders voted on the information contained inside those proxy statements without knowledge of the nature of the backdating having occurred.²⁶¹ Once re-elected, board members could then continue the process of backdating.²⁶² The corporation was harmed by distributing corporate assets inefficiently, causing an SEC inquiry, and causing reputational damage within the investing community.²⁶³ Plaintiff alleged that had the shareholders known of the backdating, those shareholders would not have voted affirmatively on the proxy statements.²⁶⁴

5. *Special Committees and Demand Futility*

Derivative actions filed in either a federal district or a New York supreme court must meet a demand futility test.²⁶⁵ The New York Business Corporation Law § 626(c) requires plaintiffs in a shareholder derivative action to plead with particularity that a demand was made to the Board of Directors to initiate the action on behalf of the corporation, or that such demand would have been futile.²⁶⁶ In New York a demand is futile, and therefore excused, where a majority of the directors are interested in the transaction(s) in dispute, or the directors were not reasonably informed about the transaction(s), or the directors failed to use business judgment regarding the transaction(s).²⁶⁷

258. *Compare In re iBasis, Inc. Derivative Litigation*, 2007 WL 4287591 (D. Mass. 2007) (Shareholders also argued, via derivative action, that § 14(a) of the 1934 Act was violated by false or misleading proxy statements. The court dismissed the claim for several reasons. First, the court considered the claim untimely. Second, the court dismissed the claim because the alleged backdating occurred prior to the issued proxy statement, and therefore there was no connection between the injury to the company and the statements and transactions approved by shareholder vote based on the information in that proxy.).

259. *Zoran*, *supra* note 233, at 1016. *Compare Fisher v. Kanas*, 467 F. Supp. 2d 275, 281-284 (E.D.N.Y. 2007) (plaintiff failed to allege: that the proxies contained specific misstatements regarding compensation; that causation existed, as there was no allegation that the proxy votes would have been different; and there were no allegations that there was a plaintiff injury as a result of the misstatements).

260. *Zoran*, *supra* note 233, at 1016.

261. *Id.*

262. *Id.*

263. *Id.*

264. *Id.*

265. *See e.g. Plymouth Cty. Retirement Ass'n v. Shroeder*, 576 F.Supp.2d 360, 369, 374-375, 378-380, 383 (E.D.N.Y. 2008) (discussing the various requirements a plaintiff derivative action must satisfy in a federal court, including: the demand futility test, statute of limitations requirements, and sufficiency of the pleadings under, *inter alia.*, the Private Securities Litigation Reform Act of 1995 ("PSLRA")).

266. N.Y. BUS. CORP. LAW § 626(c) (McKinney 2003).

267. *Marx v. Akers*, 88 N.Y.2d 189 (N.Y. 1996). The Court in *Comverse* elaborated on this third test, finding a demand on the Board futile "when [the] complaint alleges with particularity that the challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors." *In re Comverse Technology Inc., Derivative Lit.*, 866 N.Y.S.2d 10, 16-17 (quoting *Ryan v. Gifford*, 918 A.2d 341, 354-356 (Del. Ch. 2007)).

Although the plaintiffs in *Comverse*²⁶⁸ had successfully plead two of the three tests for demand futility, the trial court dismissed the claim because the director defendants had created a special committee to internally investigate the backdating matter.²⁶⁹ The trial court found the special committee represented the Board's willingness to remedy the problem on behalf of the corporation, rendering the demand futility question moot.²⁷⁰ The Appellate Division disagreed, however, and found the creation of the special committee, alone,²⁷¹ insufficient to establish the "board's willingness to take all the necessary and appropriate steps to obtain the relief available."²⁷² The Court reversed the trial opinion and reinstated the claim.²⁷³

6. *Backdating and Class Action*

The requirements for demand futility can be avoided if the moving party pursues class action. Class action, of course, has separate requirements which must be satisfied,²⁷⁴ but shareholders have experienced some success in option backdating cases. The Southern District Court of New York recently analyzed the sufficiency of backdating claims in *Take-Two*.²⁷⁵ Plaintiffs alleged two counts of securities fraud as regards options backdating.²⁷⁶ Count one alleged

268. *Comverse*, *supra* note 267.

269. *Id.* at 17.

270. *Id.*

271. *Id.* (citing *Katz v. Renyi*, 722 N.Y.S.2d 860 (2001)).

272. *Id.* The Court found a number of problems with the special committee. First, one of the special committee members was a director and compensation committee member for the period of interest at the litigation, suggesting a serious conflict of interest. *Id.* Two, the Court found the actions taken by the special committee "tepid." *Id.* at 17-18. For example, once the perpetrators of the fraud were found, they were kept on with the corporation as "advisors" until the SEC filed charges seeking restitution of \$ 51 million. *Id.* at 18. Compare *Wandel ex rel. Bed Bath & Beyond, Inc. v. Eisenberg, et al.*, 871 N.Y.S.2d 102 (N.Y. App. Divs. 1st Dept. 2009) (plaintiffs failed to plead with particularity what the egregious behavior was, and the corporation and its special committee had remedied the matter with repricing unvested options and adopting new controls).

273. *Comverse*, *supra* note 267, at 19.

274. (1) [A] district judge may certify a class only after making determination that each of the Rule 23 requirements has been met; (2) such determinations can be made only if the judge resolves factual disputes relevant to each Rule 23 requirement and finds that whatever underlying facts are relevant to a particular Rule 23 requirement have been established and is persuaded to rule, based on the relevant facts and the applicable legal standard, that the requirement is met; and (3) the obligation to make such determinations is not lessened by overlap between a Rule 23 requirement and a merits issue, eve a merits issue that is identical with a Rule 23 requirement." *In re Monster Worldwide, Inc. Sec. Litig.*, 251 F.R.D. 132, 133 (S.D.N.Y. 2008) (internal quotations and citations omitted). Class certification requires satisfaction of Rule 23(a)'s "familiar requirement." *Id.* (citing Fed. R. Civ. P. 23(a) (2008)). This requirement is "referred to as numerosity, commonality, typicality and adequacy of representation," and also must satisfy an additional 23(b) element. *Id.*

275. *In re Take-Two Interactive Securities Litigation*, 551 F. Supp. 2d 247 (S.D.N.Y. 2008).

276. *Id.* at 258-59. Count three was for control person liability under § 20(a) for fraud unrelated to the options backdating. *Id.* at 259. Count three was dismissed in its entirety. *Id.* at 306. Count four alleged trading with inside information against several executives pursuant to § 20A(a), as these executives were alleged to have sold their shares timed to the release of negative Take-Two news. *Id.* at 259. Section 20A(a) under the 34 Act creates a private right of action for claims of trading with inside information. *Id.* at 308-09. This action was not based on the options backdating facts, however. *Id.* at 308-12. Section 20A(a) provides:

Any person who violates any provision of [the 34 Act] or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable ... to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased ... securities of the same class. 15 U.S.C. § 78t-1(a)

fraud in light of § 10b and Rule 10b-5, where fraudulent statements regarding the backdating practices were made, causing the investing public to purchase Take-Two shares at inflated prices.²⁷⁷ Count two alleged control person liability under § 20(a) against two former CEOs and a former CFO, as these individuals controlled the corporation during the fraud perpetrated in count one.²⁷⁸

The defendants made several motions to dismiss for inadequacy in the pleadings for the § 10b and Rule 10b-5 claims, including: insufficient loss causation,²⁷⁹ material misstatements,²⁸⁰ and scienter.²⁸¹ The Court dismissed the bulk of these motions, granting in part those regarding scienter.²⁸² With respect to loss causation, the Court concluded the plaintiffs had successfully plead a diminution in share price as a result of a summer 2006 Take-Two public disclosure revealing an SEC investigation.²⁸³ This particular disclosure was credited with a 7.5 percent drop in the company's share price.²⁸⁴ The loss in value and simultaneous announcement of SEC activity were sufficient to satisfy the causation element.²⁸⁵ The Court also concluded the plaintiffs had successfully plead materiality because the defendants' fraud caused the company to overstate earnings by 20 percent in 2002, 11 percent in 2003, and

(2008).

A successful private right of action under § 20A(a) requires the moving party to: (1) plead a predicate insider trading violation of the [34 Act] (*see* Jackson Nat'l Life Ins. Co. v. Merrill Lynch & Co., 32 F.3d 697, 703 (2d Cir. 1994); *In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 664(S.D.N.Y. 2007)); and (2) allege sufficient facts showing "that the defendant traded the security at issue 'contemporaneously' with the plaintiff." *In re Openwave Sys. Secs. Litig.*, 528 F. Supp. 2d 236, 255 (S.D.N.Y. 2007). Take-Two, 551 F. 2d at 309.

277. *Id.* at 258.

278. *Id.* at 259.

279. Loss causation is required under § 10b and Rule 10b-5 claims. *Id.* at 282. A plaintiff must allege that losses were caused by defendant misstatements or omissions that "concealed something from the market that, when disclosed, negatively affected the value of the security." *Id.* (citing *Lentel v. Merrill Lynch & Co.*, 396 F.3d 161, 173 (2d Cir. 2005)).

280. Materiality is required in Rule 10b-5 claims. Take-Two, 551 F. Supp. 2d at 290-291. A plaintiff must plead that a defendant statement or omission that a "reasonable investor would have considered significant in making investment decisions." *Id.* (citing *Ganin v. Citizens Utils. Co.*, 228 F.3d 154, 161 (2d Cir. 2000)).

281. *Id.* at 282. Scienter is required for claims pursuant to § 10(b) and Rule 10b-5. *Id.* at 293. The plaintiff must allege facts "giving rise to a strong inference that the defendant acted with 'an intent to deceive, manipulate or defraud.'" *Id.* (citing *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d Cir. 2001)). This inference of scienter can be based on facts showing the defendant had a motive and opportunity to commit the alleged acts, or alternatively, "strong circumstantial evidence of conscious misbehavior or recklessness." *Id.* (citing *ATSI Communications, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007)). The inference is considered "strong" if it is as plausible as other, non-fraudulent explanations for the defendant's behavior. *Id.* (citing *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2510 (2007)). To properly plead motive, "a plaintiff 'must assert a concrete and personal benefit to the individual defendants resulting from the fraud.'" *Id.* at 294 (citing *Kalnit*, 264 F.3d at 139). To properly plead opportunity, a plaintiff "must show that the [] defendants possessed 'the means and likely prospect of achieving concrete benefits by the means alleged.'" *Id.* at 297 (citing *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994)).

282. Take-Two, *supra* note 275, at 313.

283. *Id.* at 282.

284. *Id.* at 287.

285. *Id.* (citing *In re Dura Pharm. Inc. Secs. Litig.*, 452 F. Supp. 2d 1005, 1021-23 (S.D. Cal. 2006); *In re Openwave Sys. Secs. Litig.*, *supra* note 276, at 252-253 (4.5 % drop)).

nearly 6 percent in 2004-2005.²⁸⁶ Plaintiffs successfully alleged that a reasonably objective investor would have taken this information into consideration before purchasing Take-Two shares, and therefore materiality was present.²⁸⁷ Although the Second Circuit has refused to create hard-and-fast quantitative markers of materiality, “the significant overstatement of a company’s earnings may constitute a ‘material’ misrepresentation.”²⁸⁸

The plaintiffs also successfully alleged the § 10b and Rule 10b-5 element scienter against several of the defendants: one CEO,²⁸⁹ several compensation committee members,²⁹⁰ and Take-Two as a corporation.²⁹¹ In the instance of the CEO, the Court considered the backdating admissions made to the Manhattan District Attorney’s office sufficient to infer an intent to make false statements, and that such an inference was more believable than innocent explanations for the CEO’s conduct.²⁹² Regarding the compensation committee members, the Court considered the allegations well-plead as regards both motive and opportunity.²⁹³ The committee members allegedly received backdated options.²⁹⁴ This constituted motive,²⁹⁵ and was evidenced by each committee member reaching an agreement with the corporation to repay the value of the inappropriately backdated options.²⁹⁶ It was also adequately alleged that the compensation committee defendants sat on the committee when the options were backdated, and were in fact responsible for determining the exercise price for the options.²⁹⁷ The Court went further and considered it dispositive that the compensation committee defendants had the ability to “influence the drafting and preparation” of the company’s public disclosures.²⁹⁸ The Court did not give weight to the explanations by defendants of their innocence,²⁹⁹ but rather concluded facts taken as alleged constituted opportunity.³⁰⁰ As regards the corporation, the Court reasoned,

286. *Id.* at 293 (earning percentages, as disclosed in Take-Two’s 2006 restated 10k).

287. *Id.* at 291.

288. *Id.* (citing *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 166 (2d Cir. 2000); *SEC v. Penthouse Int’l, Inc.*, 390 F. Supp. 2d 344, 354 (S.D.N.Y. 2005); *In re Kidder Peabody Sec. Litig.*, 10 F. Supp. 2d 398, 409-12 (S.D.N.Y. 1998)). Compare *Basic Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988) (material is judged at the time the misrepresentation or omission entered the market, as opposed to when the fraud was revealed); *Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) (different test for materiality, where the price of the stock is evaluated following the disclosure).

289. *Take-Two*, *supra* note 275, at 293.

290. *Id.* at 293-94.

291. *Id.* at 305-06. Scienter was also found as regards three directors who sat on Take-Two board’s compensation committee. *Id.* at 294 (where each director had entered a private agreement with the company to repay Take-Two, *see infra* note 296).

292. *Id.* at 293 (former CEO Brant plead guilty in New York state court to falsifying business records; his plea agreement contained admissions of stock option backdating).

293. *Id.*

294. *Id.* at 294.

295. *Id.* at 294, 297.

296. *Id.* at 294 (defendant Emmel repaid \$ 171,494, defendant Flug repaid \$305,720, defendant Grace repaid \$ 249,927).

297. *Id.* at 297.

298. *Id.* at 297-98.

299. *Id.* at 301.

300. *Id.* at 298.

"Courts readily attribute [] the scienter of management-level employees to corporate defendants."³⁰¹ In this case, the plaintiffs had adequately alleged scienter against the former CEO and compensation committee members, which therefore reflected on the corporation.³⁰²

The *Take-Two* Court also addressed a claim of control person liability under § 20(a) against former executives, two CEOs and a CFO.³⁰³ *Take-Two* defined control as "'the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.'"³⁰⁴ Here, although the plaintiffs successfully alleged that two former CEOs and a former CFO influenced the content and dissemination of various false statements and day-to-day supervision of the corporation,³⁰⁵ plaintiffs failed to plead culpable participation for any defendant other than one of the former CEOs.³⁰⁶ Culpable participation requires that a defendant have a reckless mental state,³⁰⁷ or alternatively, that scienter was "adequate[ly]" plead.³⁰⁸ In this case, plaintiffs failed to establish a reckless state of mind.³⁰⁹ The pleadings did not allege that the former president and second CEO knew or should have known of the corporation's fraudulent misrepresentation of the company's options granting policy.³¹⁰

The corporation settled with the SEC and the Manhattan District Attorney's office for \$3.3 million.³¹¹ Several of the executive defendants have individually plead guilty to falsifying *Take-Two* documents to accomplish the backdating.³¹² The class action in the Southern District Court of New York

301. *Id.* at 305 (citing *In re Marsh & McLennan Cos., Inc. Sec. Litig.*, 501 F. Supp. 2d 452, 481 (S.D.N.Y. 2006)).

302. *Id.* at 306.

303. *Id.*

304. *Id.* at 307 (citing *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472-73 (2d Cir. 1996) (quoting 17 C.F.R. § 240.12b-2)). Section 20(a) provides:

[e]very person who, directly or indirectly, controls any person liable under any provision of [the Exchange Act] or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. *Id.* at 306 (citing 15 U.S.C. § 78t(a)). In the Second Circuit, a plaintiff must plead: (1) there was an underlying primary violation, (2) the defendant exercised control over the primary violator, and (3) the defendant culpably participated in the primary violation. *Id.* (citing *In re Marsh & McLennan*, 501 F. Supp. 2d at 493). This element test is slightly different from that used in *Zoran*, *supra* note 252.

305. *Take-Two*, *supra* note 275, at 307.

306. *Id.* (lead plaintiffs' plead successfully against defendant Brant, only).

307. *Id.* at 308 (as required by § 10(b) and Rule 10b5, citing *Marsh*, 501 F. Supp. 2d at 494). Plaintiffs also must satisfy the stringent pleading requirements of the PSLRA, pleading their allegations with particularity. *Take-Two*, *supra* note 275, at 308 (discussing 15 U.S.C. § 78u-4(b)(2) (2008)).

308. *Id.* (citing *In re AOL Time Warner, Inc. Sec. & "ERISA" Litig.*, 381 F. Supp. 2d 192, 235 (S.D.N.Y. 2004)).

309. *Id.* at 309.

310. *Id.*

311. ASSOC. PRESS, *Take-Two Settles Stock Options Backdating Case*, Apr. 1, 2009, at ¶¶ 2, 7, available at <http://www.thestreet.com/story/10480741/1/take-two-settles-stock-options-backdating-case.html>.

312. Former CEO Ryan Brant plead guilty in 2007 to first-degree felony of falsification of business records, paying \$7.2 million in restitution. *Id.* ¶ 3. Several other executives plead guilty that same summer to

settled in agreement for more than \$20 million.³¹³

It is important to emphasize the similarly plead claims that have not survived motions to dismiss.³¹⁴ Many claims are also settled out of court before they reach trial.³¹⁵ Further, please note that though this section has focused on claims arising under the 33 and 34 Acts, such claims represent only a portion of the possible civil and criminal actions that could be brought in the context of stock options backdating.³¹⁶

falsifying company records. *Id.* ¶ 4.

313. Press Release, Take-Two Interactive, Take-Two Interactive Software, Inc. Announces Settlement of Securities Class Action, available at <http://ir.take2games.com/releasedetail.cfm?ReleaseID=406450> (Sept. 1 2009).

314. Most courts, however, allowed for later amended complaint, dismissing the claims without prejudice. See generally *In re Hansen Natural Corp. Sec. Litigation*, 527 F. Supp. 2d 1142 (C.D. Cal. 2007) (class action dismissed because allegations did not include financial detail assessing impact); *In re CNET Networks, Inc., Derivative Litigation*, 2008 U.S. Dist. LEXIS 51309 (N.D. Cal. 2008) (derivative action which failed to properly allege demand futility, even after third amended complaint); *In re Openwave Sys.*, 2008 U.S. Dist. LEXIS 32589 (N.D. Cal. 2008) (derivative action where statistical analyses provided were insufficient to reasonably infer backdating); *Rudolph v. UT Starcom*, 2008 U.S. Dist. LEXIS 63990 at **19-20 (N.D. Cal. 2008) (class action that was dismissed in part because plaintiff failed to make the "essential link" argument required in allegations that involve proxy statements); *Britton v. Parker*, 2008 U.S. Dist. LEXIS 70430 (D. Colo. 2008) (derivative action dismissed because allegations were insufficiently specific); *Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, 595 F. Supp. 2d 1253 (M.D. Fla. 2008) (class action dismissed upon third amended complaint for, *inter alia*., insufficient fraud admissions and insufficient detail as to misconduct); *In re Keithley Instruments, Inc., Derivative Litigation*, 2008 U.S. Dist. LEXIS 107781 (N.D. Ohio 2008) (derivative action dismissed for failure to make a demand upon the board); *Winters v. Stemberg*, 529 F. Supp. 2d 237 (D. Mass. 2008) (derivative action did not adequately allege scienter); *In re Comverse Technology, Inc. Securities Litigation*, 543 F. Supp. 2d 134, 155-156 (E.D.N.Y. 2008) (class action where claims were dismissed in part, *inter alia*., failure to satisfy the PSLRA), *accounting claims independent of backdating claims dismissed*, 2008 U.S. Dist. LEXIS 55032 at **2-3 (2008); *In re Openwave Systems*, *supra* note 267 (class action dismissed in part because control person liability and scienter were misplead as to some defendants); *Pedroli v. Bartek*, 564 F. Supp. 2d 683, 689 (E.D. Tex. 2008) (derivative action, "scatter-gun" pleading insufficient). See also Posting of Kevin M. LaCroix to D&O Diary, <http://www.oakbridgeins.com/clients/blog/optionsbackdatingtable.doc> (last updated Mar. 17, 2010) [hereinafter *Settlement Table*].

315. Settlements include: Mercury Interactive options class action settlement for \$ 177.5 million; KLA-Tencor options class action settlement for \$65 million; and Brocade options class action settlement for \$160 million. Settlement Table, *supra* note 314, at 2.

316. See, e.g. SEC v. Mercury Interactive, LLC, 2008 U.S. Dist. LEXIS 107706 at **6, 26 (N.D. Cal. 2008). After having settled with the corporation itself for a fine of \$28 million, the SEC pursued four high level executives with various fraud allegations. *Id.* The SEC sought permanent injunctive relief, disgorgement of wrongfully obtained benefits plus prejudgment interest, civil monetary penalties, an order precluding the Individual Defendants from serving as officers or directors of any public company, and repayment of bonuses and stock profits. *Id.*

The court dismissed several claims, but not those alleging fraud in the purchase and sale of Mercury stock, as well as claims of false financial statement certifications. *Id.* at *26. It should be noted that claims made against former Mercury General Counsel Susan Skaer, now Tanner, were recently dismissed. Dan Levine, *Judge Dismisses SEC Case Against Mercury Interactive's Former GC*, LAW.COM, Sept. 18 2009, http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202433875438&Judge_Dismisses_SEC_Case_Against_Mercury_Interactives_Former_Legal_Chief=&src=EMCEmail&et=editorial&bu=Corporate%20Counsel&pt=Corporate%20Counsel%20Daily%20Alerts&cn=cc20090918&kw=Judge%20Dismisses%20SEC%20Case%20Against%20Mercury%20Interactive's%20Former%20Legal%20Chief.

Both the *Broadcom* and *Brocade* cases are interesting in the breadth of litigation undertaken from the same backdating fact patterns. To date, there has been: separate shareholder derivative and class actions, criminal indictments against executives, and civil enforcement actions by the SEC. See e.g. *In re Brocade Derivative Litig.*, 2009 U.S. Dist. LEXIS 295 (N.D. Cal. 2009) (dismissed claims in part against defendants because, *inter alia*., the 10b allegations were flawed as evidence was insufficient regarding Canova and the

D. BANKRUPTCY CODE³¹⁷

For companies that file for bankruptcy, creditors may be able to recover compensation paid by the debtor corporation to its executives.³¹⁸

1. Key Employee Retention Programs

The Enron and WorldCom crises of 2000 can also be credited with the legislative effort to stop corporate insiders from benefiting while the corporation fights for survival in bankruptcy.³¹⁹ In particular, there appears to be clear Congressional intent addressing the oftentimes substantial executive pay packages awarded, despite the dramatic job losses labor and non-

reliance element was not met regarding Reyes); SEC v. Reyes, 2008 U.S. Dist. LEXIS 65895 (N.D. Cal. 2008) (action is against then Broadcom CEO Reyes, VP Jensen, and CFO Canova; pending); SEC v. Byrd, No. 07-4223-CRB (N.D. Cal. filed Aug. 17, 2007) (action is against then Brocade CFO and COO Byrd; pending); Roth v. Reyes, 2007 U.S. Dist. LEXIS 66066 (N.D. Cal. 2007) (Broadcom litigation dismissed for failure to state a claim upon which relief could be granted); Smajlaj v. Brocade, 2006 U.S. Dist. LEXIS 97618 (N.D. Cal. 2005), *defendant motion to dismiss denied*, 2007 U.S. Dist. LEXIS 64968 (N.D. Cal. 2007), *partial summary judgment granted in favor of plaintiffs*, 2008 U.S. Dist. LEXIS 38885 (N. D. Cal. 2008); *U.S. v. Reyes*, 2007 U.S. Dist. LEXIS 27427 (N.D. Cal. 2007), *criminal conviction against Broadcom CEO Reyes overturned*; *U.S. v. Reyes*, No. 08-10047 (N.D. Cal. Aug. 18, 2009), *criminal conviction of Broadcom human resource executive Jensen upheld with resentencing*; *U.S. v. Jensen*, No. 08-10140 (N.D. Cal. 2009). In December 2009, separate criminal and civil suits were dismissed against various former Broadcom executives. Amanda Bronstad, *Off the Hook: Judge Tosses Out Broadcom Prosecutions*, NAT'L L. J., Dec. 16, 2009, available at http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202436348562&Off_the_Hook_Judge_Tosses_Out_Broadcom_Prosecutions=&src=EMC-Email&et=editorial&bu=Corporate%20Counsel&pt=Corporate%20Counsel%20Daily%20Alerts&cn=cc20091215&kw=Off%20the%20Hook%3A%20Judge%20Tosses%20Out%20Broadcom%20Prosecutions (against former CFO William Ruehle, co-founder Henry Nicholas, co-founder Henry Samuelli, and former general counsel David Dull). Later that month the company settled outstanding shareholder suits. Karen Gullo, *Broadcom to Pay \$160.5 Million, End Backdating Suits (Update1)*, BUSINESS WEEK, Dec. 30, 2009, available at <http://www.businessweek.com/news/2009-12-30/broadcom-to-pay-160-5-million-end-backdating-suits-update1-.html>. The Brocade corporation released a press release in 2008 announcing a preliminary settlement of \$160 million to resolve the class action against it. Press Release, Brocade Communications Systems, Brocade Reaches Settlement in Federal Securities Class-Action Lawsuit (June 2, 2008), available at http://newsroom.brocade.com/article_display.cfm?article_id=491. The corporation also settled with the SEC, paying a \$7 million penalty without either admitting or denying the backdating allegations. SEC, Lit. Release No. 20137, <http://www.sec.gov/litigation/litreleases/2007/lr20137.htm> (May 31, 2007). See Section 17(a) of the Securities Act of 1933, 18 U.S.C. § 77q(a) (2009), providing a private right of action for fraudulent interstate transactions, and frequently alleged with § 10b and Rule 10b-5 claims in the context of options backdating. See, e.g., SEC v. Schroeder, 2008 U.S. Dist. LEXIS 46465 at *2 (N.D. Cal. 2008) (17(a) in context of stock options backdating); Goldman v. McMahan, 1987 U.S. Dist. LEXIS 5356 at *39 (S.D.N.Y. 1987) (17(a) private right of action exists).

317. This section is not intended to be an exhaustive investigation of the Bankruptcy Code or creditor rights; but rather, is a fair representation of possible actions brought under the circumstances of a corporation facing bankruptcy. See *infra* note 342 and accompanying text (creditor rights under New York state law).

318. Posting of Jesse Fried to The Harvard Law School Corporate Governance Forum ¶ 4, <http://blogs.law.harvard.edu/corpgov/2008/10/04/uncle-sam-should-claw-back-wall-street-bonuses/> (Oct. 4, 2008 09:11 EST). See *infra* discussion at 330 and accompanying text (Lehman); *infra* note 352 (Madoff); *infra* note 473 (Connecticut Attorney General Blumenthal).

319. See generally Melissa C. King, *Are KERPs Alive in Essence? The Viability of Executive Incentive Bonus Plans After 11 U.S.C. § 503(c)(1)*, 82 ST. JOHN'S L. REV. 1509, 1514-21 (2008).

management employees sustained.³²⁰ Specifically, these legislative efforts targeted retention bonuses,³²¹ or Key Employee Retention Programs (“KERP”).³²² KERPs were once used by debtor corporations to persuade existing managers to remain with the corporation through and until the conclusion of the bankruptcy proceedings.³²³ The rationale for such a practice being that those individuals who knew the business and company best were in the best position to quickly and efficiently move the company through the bankruptcy process.³²⁴ KERPs were also intended to retain management talent who otherwise would flee the sinking ship.³²⁵ The argument against this is predictable: KERPs reward the very same people who managed the company into bankruptcy.³²⁶ Recent “mega-bankruptcies” used such retention bonuses.³²⁷ WorldCom, for example, had a court approved plan to pay \$25 million in bonuses to key employees.³²⁸ Gary Winnick of Global Crossing received \$512 million; Ken Lay of Enron received \$247 million,³²⁹ and Jeff Skilling, also of Enron, received \$89 million.³³⁰ The philosophical arguments for and against KERPs aside, Congress and then President Bush acted in 2005 to eliminate them.³³¹

2. *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) amends the U.S. Bankruptcy Code³³² to limit the transfers a debtor can make during and prior to filing for bankruptcy.³³³ The trustee is

320. See generally Rebecca Revich, *The KERP Revolution*, 81 AM. BANKR. L.J. 87, 88-93 (2007).

321. See generally Raymond M. Patella, *Bankruptcy Law Reform: A Primer For the General Practitioner: Business Bankruptcies*, 77 PA BAR ASSN. Q 100, 103 (2006).

322. *New Bankruptcy Act: Employee Benefits and Executive Compensation Provisions*, McDermott Newsletters (McDermott Will & Emery) Mar. 10, 2005, at “Executive Compensation Provisions”, available at http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/30f82c89-c809-48c8-8f1b-3728eb30bcea.cfm [hereinafter *McDermott Newsletter*].

323. David A. Skeel, Jr., *Doctrines and Markets: Creditors’ Ball: The “New” Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 926-27 (2003) (also referred to as “pay-to-stay” bonuses).

324. *Id.* at 927.

325. *Id.* at 926-27.

326. *Id.* at 927.

327. *Id.*

328. Bonuses ranged between \$20,000 to \$125,000 for approximately 329 of these key employees. *Id.*

329. Creditors in Enron failed to recover over \$120 million in executive compensation, paid months before the 2001 Enron bankruptcy. Linda Sandler & Tiffany Kary, *Lehman Creditors Can Try to Recover Fuld’s Pay*, BLOOMBERG, Sept. 19, 2008, at ¶ 5, <http://www.bloomberg.com/apps/news?pid=20601103&sid=aM8r4dakjoQk&refer=news>.

330. King, *supra* note 319, at 1509 (citing Ien Cheng, *Survivors Who Laughed All the Way to the Bank: Barons of Bankruptcy Part I*, Fin. Times (London), July 31, 2002 at 10).

331. McDermott Newsletter, *supra* note 322, at ¶ 1.

332. Nichole Wong, Note, *Note and Comment: Chapter 11 Bankruptcy Under the Bankruptcy Abuse Prevention and Consumer Protection Act: The Need for Big Brother*, 29 WHITTIER L. REV. 237, 242 (2007).

333. *Id.* at 246.

given more power to set-aside these transfers.³³⁴ Three types of transfers were affected.³³⁵ First, administrative expenses, such as KERPs, were subject to significant change.³³⁶ Section 331 of BAPCPA amended § 503 of the Bankruptcy Code to add subsection (c).³³⁷ Subsection (c) is a test that debtors must meet in order to obtain court-approval of their compensation plan.³³⁸ In its broadest terms, the proposed KERP must: be essential to keep a person who has an outside job offer paying equal or higher compensation; who is essential to the survival of the business; and the KERP amount cannot be greater than certain transfers to nonmanagement employees or other insiders for the year preceding the payment.³³⁹ The test provides for more involvement by the court in reviewing debtor transfers.³⁴⁰

Second, severance payments were limited by § 331 of BAPCPA.³⁴¹ In broad terms, severance payments will not be court approved unless the amount is less than ten times the mean severance pay nonmanagement employees receive in the calendar year preceding the payment.³⁴²

Lastly, BAPCPA affected fraudulent transfers.³⁴³ Section 548 of the

334. *Id.*

335. *Id.* at 246-58.

336. *Id.* at 253.

337. *Id.* at 254; *see also infra* text discussion at 323 (discussion of post BAPCPA opinions illustrating varying courts' treatment and understanding of 503(c) application).

338. *Id.* at 254; Wong, *supra* note 332, at 254 (where "compensation plan" here refers to any transfer of funds to an upper level management employee).

339. The statutory test provides that a transfer:

To, or ... for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, ... [unless] ... (A) the transfer ... is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation; (B) the services provided by the person are essential to the survival of the business; and (C) either – (i) the amount of the transfer ... is not greater than an amount equal to ten times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made ... or (ii) if no such similar transfers were made to ... nonmanagement employees during such calendar year, the amount of the transfer ... is not greater than an amount equal to 25 percent of the amount of any similar transfer ... made to ... such insider for any purpose during the calendar year before the year in which such transfer is made.

11 U.S.C. § 503(c)(1)(A-C) (2007).

340. Wong, *supra* note 332, at 256.

341. *Id.*

342. Section 331 provides:

The payment is part of a program that is generally applicable to all full-time employees; and ... the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made.

11 U.S.C. § 503(c)(2)(A-B) (2007).

343. Wong, *supra* note 332, at 246-47. BAPCPA also affected preferential transfers. *Id.* Executive compensation is typically pursued as a fraudulent conveyance, however, and therefore preference actions will not be discussed in detail in this section. SHAKED & POSNER, PREFERENCE LITIGATION AND FRAUDULENT TRANSFER LITIGATION, WHAT IS FRAUDULENT TRANSFER LITIGATION?, <http://www.shakedandposner.com/Practice-Areas/Preference-Litigation-Fraudulent-Transfer-Litigation.shtml> (accessed May 14, 2009).

Academia has questioned whether executive compensation can be avoided by the trustee as a preferential transfer, in that it may or may not be an antecedent debt (where "antecedent debt" is required by 11 U.S.C. § 547(b)(2) (2007)). Steven H. Kropp, *Article: Corporate Governance, Executive Compensation, Corporate Performance, and Worker Rights in Bankruptcy: Some Lessons from Game Theory*, 57 DEPAUL L.

Bankruptcy Code allows a trustee to set aside fraudulent transfers.³⁴⁴ The Bankruptcy Code defines a fraudulent transfer by a debtor's "intent to hinder, delay, or defraud [creditors],"³⁴⁵ and by a nonequivalent exchange made during insolvency, or which when made created the insolvency.³⁴⁶ Pre-BAPCPA, a fraudulent transfer could be avoided if made or incurred one year prior to the bankruptcy petition.³⁴⁷ Section 548 of BAPCPA extended this reach-back to two years.³⁴⁸ BAPCPA § 548 also expanded the definition of "fraudulent transfer" to include transfers made "to or for the benefit of an insider"³⁴⁹ under an employment contract.³⁵⁰

In *Teligent*,³⁵¹ a plaintiff recovered \$12 million from a former CEO under claims of a fraudulent conveyance.³⁵² At the time of hire, the terms of the

REV. 1, 38 n. 178 (2007). Compare *Id.* at 37 n. 171 (citing *Barnhill v. Johnson*, 503 U.S. 393 (1992) (debtor checks to executives as compensation are antecedent debt)). Section 547(b) provides in part:

Except as provided in subsections (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property –

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made –

(A) on or within ninety days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if –

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

344. Wong, *supra* note 332, at 247. BAPCPA also allows a trustee to "avoid any transfer of an interest of the debtor in property ... made ... within 10 years before the date of the filing," where the debtor is the beneficiary, and the intent of the debtor in the transfer is to defraud a creditor. *Id.* at 247-148 (discussing addition of subsection (e) to § 548). Section 548 provides:

The trustee may avoid any transfer of an interest of the debtor ... made ... with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted.

Section 548 (a)(1)(A) (2007).

The trustee may avoid any transfer of an interest of the debtor in property ... that was made or incurred on or within [two] years before the date of the filing of the petition, if the debtor ... received less than a reasonably equivalent value in exchange for such transfer ... and ... was insolvent on the date that such transfer was made ... or became insolvent as a result of such transfer[.]

Section 548(a)(1)(B) (2007).

345. 11 U.S.C. § 548(a)(1)(A) (2007).

346. 11 U.S.C. § 548(a)(1)(B) (2007).

347. Wong, *supra* note 332, at 247.

348. 11 U.S.C. § 548(a)(1) (2007).

349. Kropp, *supra* note 343, at 37 n. 170 (citing 11 U.S.C. § 101(31)(b) (Supp. 2007), which defines a corporate insider to include any officer, director, or their relatives).

350. 11 U.S.C. § 548(a)(1) (2007). This language is repeated in subsection § 548(a)(1)(B)(ii)(IV), suggesting Congress is reinforcing its intent to eliminate the historical abuses that provided impetus to BAPCPA, that being a debtor freely distributing its assets prior to bankruptcy. Wong, *supra* note 332, at 247.

351. *Savage & Assocs. v. Mandl (In re Teligent Inc.)*, 380 B.R. 324 (S.D.N.Y. 2008).

352. *Id.* at 328, 336, 344 (the complaining party also requested relief, and was awarded avoidance, from a debtor transfer for \$40,000 as preferential, pursuant to § 547). The closely watched issue of alleged fraudulent

CEO's compensation agreement included a \$15 million loan.³⁵³ The agreement provided for stages of forgiveness.³⁵⁴ For example, the loan would be "automatically [] forgiven' if the company terminated the CEO without cause, or the CEO left for "good reason," before the fifth year of the CEO's employment.³⁵⁵ Additionally, there was an amendment to the compensation agreement which accelerated the loan forgiveness.³⁵⁶ Where the CEO continued in his position through the first year of employment, one-fifth of the principal, or \$3 million, would be forgiven.³⁵⁷ The CEO was employed between 1996 and 2001, thus satisfying the amendment and reducing the balance of the loan to \$12 million.³⁵⁸ When the company went through an acquisition, the CEO departed.³⁵⁹ There was a question of whether the CEO ended the employment, or whether he was terminated.³⁶⁰ The facts developed at trial persuaded the court that the CEO should have been forced into repaying the loan.³⁶¹ However, a Separation Agreement had been signed at the time of the CEO's departure which stated the CEO's termination was for something "other than cause," and restructured the loan to forgive in twenty annual

transfers is involved in the Madoff matter. The Trustee for the Madoff brokerage firm, Irving Picard, wrote hundreds of former investors, requesting they return profits and principal withdrawn from as far back as December 2002. Posting of Andrew Longstreth to The AmLaw Daily Litigation Update, <http://amlawdaily.typepad.com/amlawdaily/2009/04/the-am-law-litigation-daily-april-23-2009.html> (Apr. 23, 2009 09:00 EST). Two possible theories of recovery exist. Philip Bentley, *Legal Battle Looms for Madoff Early Exiters*, DEAL MAGAZINE, Jan. 7, 2009, ¶ 2, <http://www.thedeal.com/newsweekly/community/legal-battle-looms-for-madoff.php#bottom>. First, the trustee could recover preferential transfers made between Sept. 15 and Dec. 15 2008. *Id.* ¶ 2-3. Investors who relied on an investment intermediary may have a strong defense of holder-in-due course. *Id.* ¶ 4. Alternatively, the trustee may litigate to recover alleged fraudulent transfers. *Id.* ¶ 2 (Where these fraudulent transfers can be further categorized into intentional fraud – transfers for the purpose of specifically avoiding creditors—or constructive fraud—payments made while the firm was insolvent that were for less than fair value.). Conjecture exists that *Bayou* may be followed. *Id.* ¶ 8 (discussing *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P.*, 396 B.R. 810 (S.D.N.Y. 2008)). *Bayou* involved a decade-long Ponzi scheme, that upon discovery of such and ultimate bankruptcy filing, the court ordered investors to forfeit their profit and principal. *Id.* (discussing *Bayou*, 396 B.R. at 843). This included investors who had redeemed their interests years in advance of the bankruptcy filing, if at the time the investor redeemed she "should have known" of the fraud. *Id.* ¶ 9 (discussing *Bayou*, 396 B.R. at 845). Though this argument is anticipated to be problematic if applied to the Madoff matter: if sophisticated investigations by the SEC and institutional investors did not discover fraud over the course of years, how would an individual investor reasonably suspect fraud. *Id.* ¶ 13. The *Bayou* trustee claimed intentional fraudulent transfer, and the court ordered those investors who withdrew their funds after discovering "red flags" to forfeit profit and principal. *Id.* ¶ 10 (discussing *Bayou*, 396 B.R. at 845). The court stated the red flags should have caused further investigation on the investors' part, and absent that, the redemptions were not protected by a "good faith" transfer defense. *Id.* ¶ 11 (discussing *Bayou*, 396 B.R. at 845). See generally *Madoff Watch*, LAW.COM, available at <http://www.law.com/jsp/law/madoff.jsp> (accessed May 21, 2009).

353. *In re Teligent*, 380 B.R. at 328.

354. *Id.* at 329.

355. *Id.*

356. *Id.*

357. *Id.*

358. *Id.*

359. *Id.* at 330.

360. *Id.*

361. *Id.* at 335 (where the CEO left for no "Good Reason").

installments rather than one.³⁶² The plaintiff argued this separation agreement inappropriately released the CEO from repaying the \$12 million loan and was a fraudulent transfer.³⁶³ The facts plead showed the company transferred property to the CEO while insolvent, and for less than equivalent value.³⁶⁴ The Court found this to be a fraudulent transfer and avoided it under § 548.³⁶⁵

3. Debtor Defenses

The debtor does have recourse to defenses in bankruptcy.³⁶⁶ Under § 547(c), the ordinary course of business defense, a debtor can argue a transfer is “made in the ordinary course of business or financial affairs of the debtor and the transferee.”³⁶⁷ Alternatively, the transfer can be “made according to ordinary business terms.”³⁶⁸ In *National Gas Distributors*,³⁶⁹ the Court stated the defense involves both the dealings of the parties and the industry of the creditor as well as the “consideration of the debtor’s industry standards and the standards applicable to business in general.”³⁷⁰ Alternatively, parties can use the contemporaneous exchange for new value defense in adversary trustee claims of preferential transfers.³⁷¹ A debtor must prove the transfer was intended to be contemporaneous, for new value, and that the value exchanged

362. *Id.* at 330-31.

363. *Id.* at 332.

364. *Id.* at 333-36. The Court considered whether the CEO had forfeited claims against the company, etc., as a matter of equivalent value, but found none. *Id.* at 333.

365. *Id.* at 336.

366. Other transfer defenses, new under BAPCPA, allow the debtor to include an unavoidable transfer, or perfected security interest. Wong, *supra* note 332, at 251-52. Section 1222 of BAPCPA increases the number of days available to a debtor to perfect a security interest to avoid the trustee blocking the transfer of funds later to pay the same security interest. *Id.* at 252. An additional defense includes the unavoidable transfer under \$5,000. *Id.* Section 409 of BAPCPA amends provision nine to subsection (c) of § 547 to permit a transfer that is less than \$ 5,000 and is not wholly consumer debt. *Id.* Lastly, a trustee is prohibited from avoiding a transfer in real property interest to a “good faith purchaser” if the purchaser had no knowledge of the bankruptcy and paid “fair equivalent value.” *Id.* at 252-53 (discussing how § 1214 of BAPCPA changed 549(c)).

367. 11 U.S.C. § 547(c)(2)(A-B). Section 547(c)(2)(A-B) provides:

To the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was:

(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
(B) made according to ordinary business terms.

The defense can also be used to combat claims of preferential transfers. Wong, *supra* note 332, at 248.

368. 11 U.S.C. § 547(c)(2)(A-B).

369. *In re Natl. Gas Distributors, LLC*, 346 B.R. 394 (Bankr. E.D.N.C. 2006) (trustee won a motion for summary judgment to recover a note payment by debtor to a bank as a preferential transfer).

370. *Id.* at 405.

371. ROBERT S. BERNSTEIN, BERNSTEIN LAW FIRM, A PRIMER ON PREFERENTIAL TRANSFERS IN BANKRUPTCY ¶ 2, <http://www.bernsteinlaw.com/publications/preferential/pref8.htm> (accessed May 06, 2009). In the matter of preference litigation, a party could also rely on the Subsequent New Value defense. SHAKED & POSNER, *supra* note 343, at “What is Preference Litigation?” A party must receive full payment from the debtor in the ninety day period, and the continue to provide services or goods without receiving subsequent debtor payment. *Id.*

between the parties was equal.³⁷² The provision essentially offers incentive for third parties to continue business with the insolvent party during bankruptcy, ensuring debtor payment for goods or services is not recoverable by the trustee.³⁷³

4. Debtor Company Adaptation to 503(c)

In light of these BAPCPA limitations, some debtor companies have modified their approach to have a compensation proposal approved.³⁷⁴ Section 503(c) has been considered a “KERP Killer,” and debtors have taken the KERP characteristics—retention plans known as “pay to stay”—and recharacterized them as performance incentive plans (“PIPs”),³⁷⁵ or “produce value for pay.”³⁷⁶ Debtor counsel have tried to avoid BAPCPA § 503(c) scrutiny, and instead have sought to have incentive plans evaluated by the historic § 363 business judgment criteria.³⁷⁷ This approach was used in the case *In re Dana Corporation*,³⁷⁸ where the Court refused to accept the payment plan offered for approval as incentive-based.³⁷⁹ The debtor company filed a compensation plan that requested relief under a number of Bankruptcy Code

372. *Id.* at ¶ 2.

373. Kropp, *supra* note 343, at 37-8 n. 173 (citing 11 U.S.C. § 547(c)(1) (Supp. 2007)).

374. Revich, *supra* note 320, at 114-16 (discusses “creative lawyering”).

375. Matt Miller, *KERP Your Enthusiasm*, THE DEAL, June 22, 2007, ¶ 6, available at <http://thedeal.com/servlet/Satellite?cid=1181188647067&pagename=BI%2FBIArticle&c=TDDArticle> (accessed Apr. 25, 2009) (copy on file with author).

376. Posting of Kyle Matthews to Sheppard Mullin Bankruptcy and Restructuring Blog ¶ 1, <http://www.bankruptcylawblog.com/other-nationally-significant-cases-if-it-looks-like-a-duck-kerp-and-quacks-like-a-duck-kerp-its-a-duck-kerp-1.html> (Sept. 7, 2006).

377. See generally Emily Watson Harring, Note, *Walking and Talking like a KERP: Implications of BAPCPA § 503(c) for Effective Leadership at Troubled Companies*, 2008 U. ILL. L. REV. 1285, 1293 (2008) (discussion of § 363(b)). Section 105(a) of the Code gives courts jurisdiction over debtors and debtor assets. *Id.* at 1293 n. 46 (citing 11 U.S.C. § 105(a) (2008)). Section 363(b)(1) authorizes the trustee to “use, sell, or lease, other than in the ordinary course of business, property of the estate.” *Id.* at 1293 n. 48 (citing 11 U.S.C. § 363(b)(1) (2008)). Section 363(b) requires that uses of the debtor’s property outside of the ordinary course must be approved by the court. *Id.* at 1251 n.51 (citing 11 U.S.C. § 363(b)(1)). The courts developed a two-prong test to approve KERPs under § 363(b): did the debtor use “proper business judgment” in creating the KERP, and was the KERP “fair and reasonable.” See, e.g. *In re Aerovox, Inc.*, 269 B.R. 74, 80-81 (Bankr. D. Mass. 2001); *In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 154 (Bankr. D. Del. 1999); *In re Am. W. Airlines, Inc.*, 171 B.R. 674, 678 (Bankr. D. Ariz. 1994); *In re Interco, Inc.*, 128 B.R. 229, 234 (Bankr. E.D. Mo. 1991). Anything passed unless the KERP was “so manifestly unreasonable that it could not be based upon sound business judgment, but only on bad faith, or whim or caprice.” *In re Aerovox*, 269 B.R. at 80.

378. *In re Dana Corporation*, 351 B.R. 96 (S.D.N.Y. 2006), *executive compensation motion modified and approved*, 358 B.R. 567 (S.D.N.Y. 2008) (approved on condition of a ceiling for senior executive pay during the course of the bankruptcy).

379. *In re Dana Corporation*, 351 B.R. at 102 n.3 (“If it walks like a duck (KERP) and quacks like a duck (KERP), it’s a duck (KERP).”). Compare *In re Pilgrim’s Pride Corporation*, 401 B.R. 229, *12-13 (N.D. Tex. 2009) (Trustee argued payments for a non-compete agreement were tied to severance, based on *Dana*. *Pilgrim’s* Court distinguished *Dana* in that there: it was a pre-termination agreement and not a post-severance agreement; the *Dana* non-compete agreement was included among the severance terms; and that the *Dana* plaintiffs failed to properly plead to that Court that their payments were not severance per § 503(c)(2)).

provisions, but 503(c) was not among them.³⁸⁰ The Court made clear that any payment made to induce an insider to remain with the debtor, or made as severance, must satisfy 503(c) evidentiary standards.³⁸¹ The Court found that a payment that fell in either of those categories could not be scrutinized under the § 363 business judgment rule.³⁸²

The Court ultimately concluded that the debtor's compensation proposal

380. *In re Dana Corporation*, 351 B.R. at (debtors sought relief under §§ 101(31) (definition of an insider), 105 (jurisdiction over debtor assets), 363(b) (ordinary course of business defense), 365 (administrative powers over executory contracts)).

381. *Id.* at 100-01 ("to the extent a proposed transfer falls within §§ 503(c)(1) or (c)(2)"). Section 503(c)(1) provides:

There shall neither be allowed, nor paid - - (1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court based on evidence in the record that - - (A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation (B) the services provided by the person are essential to the survival of the business; and (C) either - - (i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 [sic] times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation incurred; or (ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such non-management employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent [sic] of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred.

Id. at 101 n. 1 (citing 11 U.S.C. § 503(c)(1)). Section 503(c)(2) provides:

There shall neither be allowed, nor paid - - (2) a severance payment to an insider of the debtor, unless - - (A) the payment is part of a program that is generally applicable to all full-time employees; and (B) the amount of the payment is not greater than 10 [sic] times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made.

Id. at 101 n. 2 (citing 11 U.S.C. § 503(c)(2)).

382. *Id.* at 101 ("even if] a sound business purpose may actually exist"). Debtors had argued, in the alternative, that if the Court felt so compelled to use § 503(c), that the Court should then use § 503(c)(3). *Id.* The trustee objected to this use, arguing 503(c)(3) applies to high-level employees hired after the bankruptcy petition is filed. *Id.* The Court, however, did not feel the statute's language "prohibited" its analysis of prepetition hires under 503(c)(3). *Id.* Section 503(c)(3) provides:

There shall neither be allowed, nor paid - - (3) other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of filing of the petition.

Id. (citing 11 U.S.C. § 503(c)(3)). Debtor company also argued the Court should rely on its earlier reasoning and decision in *In re Calpine*. *Id.* at 102 (citing *In re Calpine Corp.*, No. 05-60200 (Bankr. S.D.N.Y. 2005) (the Court there found a compensation proposal incentivizing, and the decision suggests that § 503(c)(1) should be used only in circumstances where retention is the focus)). The Court distinguished *Calpine* as the objections raised in *Dana* were not raised in *Calpine*, and therefore the Court was not asked to address the same issues. *Id.* at 101-02. Too, the Court insisted any analysis of a compensation proposal under 503(c) must be a case-by-case, debtor-by-debtor, fact-specific inquiry. *Id.* The Court did indicate, however, that the business judgment rule could be used to consider a compensation motion under § 503(c)(3). *Id.* at 102. See also Revich, *supra* note 323, at 104 (discussing a hearing transcript from *In re Nobex Corp.*, 2006 Bankr. LEXIS 417 (Bankr. D.Del. Jan. 30, 2006) (No. 05-20050) that suggests 503(c)(1) is to be used only for strict retentive compensation).

did not satisfy § 503(c) BAPCPA standards.³⁸³ The Court found the completion bonus had a retentive affect, in that executives could capture nearly two thirds of their bonus if the company lost a quarter of its value.³⁸⁴ The Court did not consider this incentive-based under 503(c).³⁸⁵ Further, the severance/non-compete payment failed to satisfy § 503(c)(2)'s definition of severance.³⁸⁶ To avoid 503(c) scrutiny, debtor company re-characterized the severance payments as "exchange for non-compete agreements" upon involuntary dismissal or resigning for good reason.³⁸⁷ The Court interpreted this characterization in light of the Second Circuit's definition of severance, "amounts due whenever termination of employment occurs."³⁸⁸ The Court concluded the payments were in fact severance, and therefore subject to 503(c).³⁸⁹

Other courts have also acted to restrain executive compensation. The Court in *Ownit Mortgage Solutions*³⁹⁰ found a \$150,000 bonus outside the ordinary course of business, where the performance exchanged was relocating the company's headquarters, resolving the remaining mortgage loans, and filing a tax return.³⁹¹ The Court in *Delphi*³⁹² reduced an executive compensation plan from \$87 million to \$16.5 million for unreasonableness.³⁹³

5. *Lehman Bankruptcy*

The executive compensation topic becomes especially interesting in light of, *inter alia*, the Lehman bankruptcy and the compensation that was paid prior to entry into bankruptcy.³⁹⁴ According to a March 5, 2008, proxy statement, the top five executives at Lehman were awarded \$ 81 million dollars in bonuses; a small fraction of the \$5.7 billion in bonuses the company paid in

383. *In re Dana*, 351 B.R. at 103 (the Court indicated, broadly, that the compensation proposal would not had survived § 363 scrutiny, either).

384. *Id.* at 102.

385. *Id.*

386. *Id.* at 102-03.

387. *Id.* at 102.

388. *Id.* (citing *Straus-Duparquet, Inc. v. International Brotherhood of Electrical Workers*, 386 F.2d 649, 651 (2d Cir. 1967)).

389. *Id.* at 102-03.

390. *In re Ownit Mortgage Solutions, Inc.*, Case No. 06-12579 (KT) (N.D. Cal. filed Dec. 28, 2006).

391. Miller, *supra* note 376, at ¶ 5.

392. *In re Delphi*, Case No. 05-44481 (RDD) (S.D.N.Y. filed Oct. 8, 2005).

393. *Delphi Judge Orders Bankruptcy Emergence Bonuses Slashed, Cuts Exec Payout by 80 Percent*, WORKFORCE, Jan. 29, 2008, ¶¶ 4, 6, <http://www.workforce.com/section/00/article/25/33/46.php>.

394. *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555 (S.D.N.Y. 2008); *In re Securities Investor Protection Corp. v. Lehman Brothers Inc.*, 2008 Bankr. LEXIS 3543 (S.D.N.Y. 2008) (winding-down broker-dealer business). See *relatedly* *Bay Harbour Mgmt., L.C. v. Lehman Bros. Holdings*, 2009 U.S. Dist. LEXIS 20893 (S.D.N.Y. 2009) (investment funds who maintained prime brokerage accounts with Lehman challenged a sale order to Barclays of Lehman's investment banking and capital markets operations and infrastructure; the court affirmed the sale order). See *also, infra* note 473 (discussing Connecticut Attorney General Blumenthal's objection to debtor corporation compensation proposal).

2007.³⁹⁵ Then CEO, Richard Fuld, was awarded \$34.4 million in 2007 alone.³⁹⁶ Lehman had \$613 billion in debt when the company collapsed in 2008.³⁹⁷ Creditors may yet seek possible recovery of these monies via fraudulent transfer theory, reasoning that the company did not receive full value for its money.³⁹⁸

III. STATE AUTHORITY

A. NEW YORK STATE

1. *Common Corporate Responsibilities in New York*

Customary corporate responsibilities in New York include fiduciary duty,³⁹⁹ good faith,⁴⁰⁰ and business judgment.⁴⁰¹ This section will discuss claims stemming from these theories that parties may use to recapture executive compensation.⁴⁰² The discussion begins with the Grasso litigation and defense victory,⁴⁰³ involving the former Chairman and CEO of the New York Stock Exchange ("NYSE").

395. See Sandler and Kary, *supra* note 332, ¶ 3 (Sept. 19, 2008); Adam Levitin, *Lehman 2007 Bonuses?*, CREDIT SLIPS, Sept. 14, 2008, ¶ 1, <http://www.creditslips.org/creditslips/2008/09/lehman-2007-bon.html>.

396. Sandler and Kary, *supra* note 332, at "Most to Give Up." Then Chief Operating Officer ("COO") J.M. Gregory made \$26 million in 2008; then Chief Legal Officer ("CLO") Thomas A. Russo made \$12.1 million; then Chief Financial Officer ("CFO") C.M. O'Meara made \$3.7 million, and then Co-Chief Administrative Officer ("Co-CAO") Ian Lowitt made \$4.9 million. *Id.*

397. *Id.*

398. *Id.* ¶ 2 (reasoning "the value of the services of a CEO who runs a company into bankruptcy is less than \$34 million).

399. Directors and officers owe a fiduciary duty to the corporation. *TJI Realty, Inc. v. Harris*, 250 A.D.2d 596, 598 (N.Y. App. Div. 2d Dept. 1998) (citing N.Y. BUS. CORP. LAW §§ 717, 720 (McKinney 2003)); *Limmer v. Medallion Group*, 75 A.D.2d 299, 303 (N.Y. App. Div. 2d Dept. 1980).

400. "All corporate responsibilities [will] be discharged in good faith and with 'conscientious fairness, morality, and honesty in purpose.'" *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557, 569 (N.Y. 1984)).

401. The business judgment rule refrains judicial examination into decisions made by corporate directors, where those decisions are the result of "'good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes.'" *Owen v. Hamilton*, 44 A.D.3d 452, 456 (N.Y. App. Div. 1st Dept. 2007); *Lippman v. Shaffer*, 836 N.Y.S.2d 766, 772 (2006).

402. This section will not discuss, however, state criminal actions to combat matters of executive compensation, although such has been suggested as a possible remedy. See, e.g., Pitofsky and Tulchin, *supra* note 153, at "State Laws." See, e.g., Kozlowski, 47 A.D.3d 111 (table), 2007 N.Y. App. Div. LEXIS 11780 (N.Y. App. Div. 1st Dept. 2007), *aff'd*, 11 N.Y.3d 223 (table), 2008 N.Y. LEXIS 3202 (N.Y. 2008). *Kozlowski* involves the seemingly endless litigation of CEO and CFO of Tyco international, Dennis Kozlowski and Mark Swartz. *Id.* at 113. The Appellate Division found the defendants had taken unauthorized bonuses, and affirmed lower court convictions for larceny, conspiracy, securities fraud contrary to General Business Law § 352-c(b), and falsifying business records. *Id.* at 120-21. *Kozlowski* also involved claims arising under the Martin Act. *Id.* at 117-18 (*refer* text discussion at 44-46).

403. The *Grasso* procedural history is quite lengthy, in that not only did the matter reach each level of the New York Judiciary, but the various parties made repeated claims, counter claims, and motions over the course of the multiple year litigation (roughly 2003 to 2008). Two principal opinions, discussed throughout this section are: *People v. Grasso*, 11 N.Y.3d 64 (N.Y. 2008) ("*Grasso II*," as nicknamed in *People v. Grasso*, 54 A.D. 3d 180, 184 (N.Y. App. Div. 1st Dept. 2008)); *Grasso*, 54 A.D.3d 180.

2. *Richard Grasso Litigation*

Grasso was a party to several compensation agreements, covering the period 1995 to 2003.⁴⁰⁴ From 1995 to 2002, Grasso earned a salary of \$1.4 million.⁴⁰⁵ In contrast, in 2003 Grasso was paid a lump sum of nearly \$140 million in salary, with an additional \$48 million to be paid-out to him over the course of the next four years.⁴⁰⁶ The bonus awards to Grasso also jumped dramatically: from \$900,000 in 1995 to \$10.6 million in 2002.⁴⁰⁷ During Grasso's employment, the NYSE was organized under New York's Not-For-Profit Corporation Law ("N-PCL").⁴⁰⁸ The Attorney General's office filed a complaint asserting six causes of action against Grasso.⁴⁰⁹

Defendant Grasso moved to dismiss four of the non-statutory claims.⁴¹⁰

404. Grasso II, 11 N.Y.3d at 66.

405. *Id.*

406. *Id.*

407. *Id.*

408. *Id.*

409. *Id.* at 68 (In total, eight actions were filed: six against Grasso, one against Kenneth Langone (then Chairman of the NYSE's compensation committee), and one requesting injunctive relief against the NYSE).

(1) against Mr. Grasso for annual compensation, SERP [Supplemental Executive Retirement Program] and SESP [Supplemental Executive Savings Plan] benefits, which were unlawful and ultra vires [sic] violating the New York Not-for-Profit Law ("N-PCL"). Plaintiff seeks imposition of a constructive trust on and restitution of Mr. Grasso's compensation;

(2) for an unlawful conveyance against Mr. Grasso under N-PCL §§ 720 (a)(2) and 720 (b) for knowingly receiving annual compensation and SERP benefits that were not reasonable and unlawful. Plaintiff seeks to set aside the annual compensation and SERP payments;

(3) against Mr. Grasso for breach of fiduciary duty under N-PCL §§ 717, 720 (a) and (b) by accepting unlawful ultra vires payments. Plaintiff seeks a judgment directing Mr. Grasso to account for his official conduct and to make restitution;

(4) against Mr. Grasso for payment had and received. Plaintiff alleges that Mr. Grasso's compensation and benefits were not reasonable or commensurate with services Mr. Grasso performed and thus constitute unjust enrichment. Plaintiff seeks return of excessive compensation;

(5) against Mr. Grasso for violation of N-PCL § 715 (f) because the NYSE Board did not approve his CAP [Capital Accumulation Plan] and SERP payments. Plaintiff seeks a declaration that any obligation by the NYSE to make future payments lacking the required N-PCL § 715 (f) board approval is void and restitution by Mr. Grasso of all CAP and SERP payments;

(6) against Mr. Grasso under N-PCL § 716 for unlawful loans to Mr. Grasso made on May 11, 1995 in the amount of \$6,571,397 and May 3, 1999 in the amount of \$29,928,062;

(7) against Langone for breach of fiduciary duty under N-PCL §§ 717, 720(a) and (b), by failing to explain Mr. Grasso's proposed compensation. Plaintiff seeks an order directing Langone to account for his official conduct and to make restitution of the unlawful payments to Mr. Grasso; and

(8) against the NYSE under N-PCL §§ 202(a)(12) and 515(b) for payment of compensation and SERP benefits that were not reasonable and ultra vires. Plaintiff seeks a declaration that the NYSE paid Mr. Grasso compensation and SERP benefits that were unlawful and ultra vires. In addition, plaintiff seeks to enjoin the NYSE to adopt and implement safeguards to ensure compliance with the N-PCL.

People v. Grasso, 831 N.Y.S.2d 349, *2 (table), 2006 N.Y. Misc. LEXIS 3023 (2006) ("Grasso 2006").

410. Grasso II, 11 N.Y.3d at 68-69 (arguing the Attorney General lacked standing; the court denied the motion) (see People v. Grasso, 816 N.Y.S.2d 863 (2006)). This Court of Appeals opinion resolved actions one, four, five, and six. Grasso II, 11 N.Y.3d at 71-72. The Supreme Court had denied defendant's motion to dismiss, but was reversed at the Appellate level. *Id.* at 68-69. The Court of Appeals affirmed the Appellate level ruling regarding all four claims. *Id.* at 69.

When reviewed by the Court of Appeals, the legislative intent was dispositive of the underlying legal claims.⁴¹¹ The N-PCL codifies the business judgment rule for New York's non-profits.⁴¹² This means that liability in the case of a not-for-profit officer or director requires knowledge or bad faith.⁴¹³ The Court of Appeals found the Attorney General had "crafted"⁴¹⁴ the four non-statutory claims in such a way, that while premised on themes in the N-PCL, the claims did not satisfy this element of knowledge or bad faith.⁴¹⁵ The Court found that although doing this made the Attorney General's claims easier to prove,⁴¹⁶ failing to satisfy the knowledge or bath faith element essentially subverted the legislature's role as policy-maker.⁴¹⁷ The Court found that disregarding the N-PCL as written by the Legislature was beyond the authority of the Executive branch, in this case the Attorney General.⁴¹⁸ The Court emphasized that although the compensation may have appeared unreasonable on its face, the Attorney General could not suggest liability for that reason alone.⁴¹⁹

The remaining two claims against Grasso, both statute-based, were concluded in Grasso's favor by a separate court.⁴²⁰ The Appellate Division

411. Grasso II, 11 N.Y. 3d at 72. The Court acknowledged that although such was beyond the scope of its opinion here, that the appeal did rest on the Attorney General's "assertion of *parens patriae* authority to vindicate the public's interest in an honest marketplace." *Id.* at 70 (*refer supra* text discussion at 40-42 detailing the later Appellate Division opinion resolving the remainder of Defendant Grasso's claims, and discussing the *parens patriae* authority in greater detail).

412. *Id.* at 70 (*citing* N-PCL § 717). Officers and directors much discharge "the duties of their respective position sin good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." *Id.* (*citing* N-PCL § 717(a)). "Officers and directors are permitted to rely on information, opinions or reports of reasonable reliability so long as the officer or director acts in good faith." *Id.* (*citing* N-PCL § 717(b)). "Moreover, the statute dictates that persons "who so perform their duties shall have no liability by reason of being or having been directors or officers of the corporation." *Id.* (*citing* N-PCL § 717(b)).

413. Grasso II, 11 N.Y.3d at 71.

414. *Id.* at 70.

415. *Id.* at 71.

416. *Id.*

417. *Id.* at 72.

418. *Id.* at 70.

419. *Id.* at 72.

420. Grasso, 54 A.D.3d at 210, 213-14 (this opinion resolved actions two and three against Grasso). The two claims asserted against Kenneth Langone and the NYSE itself, *refer supra* note 409 (the seventh and eighth causes of action, respectively), were also addressed in this opinion. *Id.* at 210, 213-14.

Langone had made a motion to the Supreme Court to dismiss the action against him, which was denied. Grasso 2006, 831 N.Y.S.2d 349. The Appellate Division, however, reversed the Supreme Court and granted Langone's motion and dismissed the action. Grasso, 54 A.D.3d at 214. The Appellate Division reasoned the Attorney General had lost his standing when the NYSE changed from a not-for-profit corporation to a for-profit corporation. *Refer* text discussion at 166-67; Grasso, 54 A.D.3d at 198-99.

The Supreme Court granted Grasso's motion to dismiss the Attorney General's claim for injunctive relief against the NYSE. Grasso, 54 A.D.3d at 210 (discussing Grasso 2006, 831 N.Y.S.2d at *33). The Supreme Court reasoned the NYSE's new for-profit status rendered the action "moot." *Id.* Grasso had also asked for declaratory relief regarding the eighth cause of action, which the Supreme Court denied. *Id.* The Appellate Division agreed with this ruling, but for different reasoning: Grasso had no standing vis-à-vis the Exchange to be bound by the dismissal, and therefore had no standing to seek this dismissal. *Id.*

The NYSE entity change was dispositive as to actions two, three, and seven in this opinion. *Id.* at 189-90.

reversed a Supreme Court ruling stating the Attorney General's enforcement power had not lapsed when the NYSE became a for-profit corporation.⁴²¹ The Appellate Division reasoned that although the N-PCL explicitly authorizes the Attorney General to bring suit on behalf of a not-for-profit corporation for non-compliance by the not-for-profit executives, there is no such enforcement provision on behalf of a for-profit corporation.⁴²² Additionally, although there is statutory authorization for such litigation to continue under these circumstances,⁴²³ there is no statutory provision for standing by the Attorney General to continue.⁴²⁴ The Appellate Division refused to infer such a right.⁴²⁵

The Court analyzed *parens patriae* as a possible means of allowing the Attorney General's litigation to continue.⁴²⁶ *Parens patriae* is a common law doctrine where the sovereign can initiate a legal action to protect those who are unable to litigate on their own behalf.⁴²⁷ *Parens patriae* requires the Attorney General have some quasi-governmental interest in representing the private parties, apart from the interest the private parties themselves have in the

The Court, however, also composed separate reasoning as to why the Supreme Court's treatment of the third action against Grasso, alleging he violated his fiduciary duties by influencing and accepting excessive compensation, contrary to N-PCL 717(a) and 720(a)(1)(A-B), was incorrect. *Id.* at 185. The Supreme Court had ruled Grasso violated this duty. *Id.* at 189. Grasso participated in two NYSE benefit programs. *Id.* at 185. One was a retirement plan referred to as the Supplemental Executive Retirement Plan ("SERP"). *Id.* (Grasso did not participate in NYSE's formal SERP program, but an equivalent program.) *Id.* The second was a savings plan, referred to as the Supplemental Executive Savings Plan ("SESP"). *Id.* With respect to SERP, the Supreme Court ruled that the compensation committee and board of directors were not "fully informed" of Grasso's benefits, and that Grasso knew or should have known this. *Id.* at 186. The Appellate Division found evidence, however, that a reasonable trier of fact could have concluded both: that the board had knowledge of Grasso's benefits, and that Grasso believed this. *Id.* As regards SESP, the Appellate Division rejected the Supreme Court's characterization of Grasso's early pay-out as *ultra-vires*, and therefore a breach of Grasso's fiduciary duty in accepting such. *Id.* at 187. The Appellate Division found the board had not committed the NYSE indefinitely to the terms adopted under SESP, and that the Exchange had the power to amend SESP via Grasso's 2003 compensation agreement. *Id.*

421. *Id.* at 189-190. Regarding the for-profit transformation: the then lead seat owner sued the NYSE to halt a proposed acquisition that would make the not-for-profit NYSE a for-profit corporation. See Higgins v. New York Stock Exch., Inc., 10 Misc. 3d 257 (2005). The suit was ultimately settled out of court. Michael J. Martinez, *NYSE Dissidents Settling Their Suit to Block Archipelago Deal*, SEATTLE TIMES, Nov. 15, 2005, ¶ 1, available at <http://community.seattletimes.nwsourc.com/archive/?date=20051115&slug=webnyse15>.

422. Grasso, 54 A.D.3d at 190-91, 193-94. The matter of a not-for-profit organization becoming a new for-profit entity during litigation, and whether the Attorney General's power under N-PCL 720(b) was affected, was a question of first instance that divided the court. *Id.* at 183.

423. *Id.* at 191 (citing N.Y. BUS. CORP. LAW § 906(b)(3), as enforced by N-PCL 908(i)(A-B)).

424. *Id.* (citing Rubinstein v. Catacosinos, 91 A.D.2d 445 (1983); *aff'd* 60 N.Y.2d 890 (1983)). The Court continued this reasoning, indicating that it is not enough for standing to exist at the onset of litigation, but that such standing must continue until the matter is concluded. *Id.* at 197 (citing Stark v. Goldberg, 297 A.D.2d 203, 204 (2002)).

425. *Id.* at 191.

426. *Id.* at 193-194.

427. People v. Grasso, 12 Misc. 3d 384, 393 (citing Hawaii v. Standard Oil Co. of Cal., 405 U.S. 251, 257 (1972)). There are three requirements for an Attorney General to rely on her *parens patriae* authority. *Id.* at 395 (citing Alfred L. Snapp & Son, Inc. v. Puerto Rico ex rel. Barez, 458 U.S. 592, 607 (1982)). The sovereign must: have a sovereign or quasi-sovereign of the public; that interest must affect a "substantial segment" of the citizenry; and the sovereign must have an interest in the litigation separate from the interests of the involved private parties. *Id.* (citing Snapp, 458 U.S. at 607).

litigation.⁴²⁸ The Court reasoned, however, there was no public policy concern in the *Grasso* matter.⁴²⁹ Further, the Court considered a corporation engaging in active business as in no need of the “nursing quality” of the *parens patriae* power of the State,⁴³⁰ and that the wronged parties had “ample remedies” to pursue resolution of the matter on their own initiative.⁴³¹ Problematic for the Attorney General in this regard was that money damages were sought against the NYSE as the sole remedy.⁴³² Not only would it had been ironic to return these money damages to a now for-profit corporation,⁴³³ but the Second Circuit has ruled money damages are an inappropriate remedy to protect the integrity of the state’s marketplace.⁴³⁴

3. *Corporate Waste*

Other remedies under New York common law include a claim for corporate waste.⁴³⁵ An officer or director is responsible for mismanagement of corporate assets, and can be held to account for her mismanagement or misconduct.⁴³⁶ For a claim of corporate waste in executive compensation, a plaintiff must plead and allege that executive “compensation rates [were] excessive on their face or other facts which call into question whether the compensation was fair to the corporation when approved, the good faith of the directors setting those rates, or that the decision to set the compensation could not have been a product of valid business judgment.”⁴³⁷ This test was

428. *Grasso*, 54 A.D.3d at 198 (citing *Snapp*, 458 U.S. at 607).

429. *Id.* at 194.

430. *Id.* at 193 (citing *People v. Ingersoll*, 58 N.Y. 1, 30 (1874)).

431. *Id.* at 193-94 (citing *People v. Lowe*, 117 N.Y. 185, 195 (1889)).

432. *Id.* at 197.

433. *Id.* at 192 n. 7, 194-96.

434. *Id.* at 197 n.10 (citing *New York v. Seneca*, 817 F.2d 1015, 1017-1018 (2d Cir. 1987) (money damages were rejected as an appropriate remedy for private parties where the state injury was the “integrity of the state’s marketplace and economic well-being of all citizens”)).

435. A director or officer is liable for misconduct with corporate assets, as regards the “acquisition by [her]self, transfer to others, loss or waste of corporate assets due to any neglect of, or failure to perform, or other violation of [her] duties.” *Kossoff v. Samsung Co.*, 123 Misc. 2d 177, 179 (1984). Claims for “excessive compensation” belong to the corporation and must be brought derivatively via the corporate waste action. *Savage & Assocs., P.C. v. Mandl (In re Teligent, Inc.)*, 358 B.R. 45, 56 (S.D.N.Y. 2006) (citing *Marx v. Akers*, 88 N.Y.2d 189 (N.Y. 1996)).

436. *Kossoff*, 123 Misc. 2d at 179.

437. *Fischbein v. Beitzel*, 721 N.Y.S.2d 515, 516 (N.Y. App. Div. 1st Dept. 2001) (citing *Marx*, 88 N.Y.2d at 198 (though in all fairness, *Marx* is typically cited by New York courts for the demand futility test it established for plaintiffs in a derivative action, *refer supra* text discussion at 332). *Marx* went further, indicating that at trial, if the directors involved were disinterested, a plaintiff would have to prove wrongdoing or waste. *Marx*, 88 N.Y.2d at 204 n. 6. Moreover, if the directors approved their own compensation, the burden of proof shifted to those directors to prove the transactions were fair to the corporation. *Marx*, 88 N.Y.2d at 204 n. 6. In *Marx*, the pleadings failed to make any fact-based allegations, and were considered by the court to be conclusory. *Marx*, 88 N.Y.2d at 204 (plaintiffs had in fact plead generally, that the compensation bore little resemblance to the services provided, that those services had not improved the company’s performance, or that the compensation increase was larger than that required by the cost of living).

announced by the Court of Appeals of New York in *Marx*,⁴³⁸ but was limited by the Court's reluctance to review matters of executive compensation.⁴³⁹ Cases subsequent to *Marx* follow *Marx* for the demand futility test it announced, but not the element test for the recoupment of executive compensation under the claim of corporate waste.⁴⁴⁰ Older cases discussing executive compensation and corporate waste echo similar themes.

In *Baker*,⁴⁴¹ for example, a 1942 New York trial court found that directors and officers of a corporation had abused their fiduciary duties by awarding themselves excessive compensation.⁴⁴² The Court ordered them to repay monies to the corporation.⁴⁴³ The Court reasoned that officers' and directors' salaries must bear some proportional relationship to the services rendered and the income of the business.⁴⁴⁴ Where the compensation was so disproportionate a rebuttable presumption existed that the defendants had acted in their own interest at the cost of the company's.⁴⁴⁵ The defendants in *Baker* failed to defeat that presumption.⁴⁴⁶ *Stearns*,⁴⁴⁷ a 1948 case, used the same rebuttable presumption⁴⁴⁸ and similar reasoning.⁴⁴⁹ In that case, a group of

438. *Marx*, 88 N.Y.2d at 203-204.

439. *Id.* at 203.

"The courts will not undertake to review the fairness of official salaries, at the suit of a shareholder attacking them as excessive, unless wrongdoing and oppression or possible abuse of a fiduciary position are shown. However, the courts will take a hand in the matter at the instance of the corporation or of shareholders in extreme cases."

Id. *Marx* is further weakened by a number of other factors. First, *Marx* cited secondary sources in order to form the element test. *Id.* at 203-204 (citing, respectively, FLETCHER, CYCLOPEDIA OF PRIVATE CORPORATIONS 5A, § 2122, 46-47 (1995); BLOCK, BARTON & RADIN, BUSINESS JUDGMENT RULE, 149 (4th ed. 1993); FLETCHER, CYCLOPEDIA OF PRIVATE CORPORATIONS 2, § 514.1, 632 (1990); 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 5.03). Second, the claim in *Marx* was ultimately dismissed for conclusory allegations. *Id.* at 204 ("bare allegations that the compensation set lacked a relationship to duties performed or to the cost of living are insufficient").

440. See generally *Bansbach v. Zinn*, 1 N.Y.3d 1, 12 (N.Y. 2003); *In re of Omnicom Group Inc.*, 842 N.Y.S.2d 408, 410 (N.Y. App. Div. 1st Dept. 2007); *Billings v. Bridgepoint LLC*, 863 N.Y.S.2d 591, 593 (2008).

441. *Baker v. Cohn*, 42 N.Y.S.2d 159 (1942), *modified*, 266 A.D. 715 (N.Y. App. Div. 1943), *aff'd*, 292 N.Y. 570 (N.Y. 1944).

442. *Id.* at 167.

443. *Id.* at 167-68.

444. *Id.* at 165-66 (citing a district court case in the eighth circuit, *Backus et al. v. Finkelstein et al.*, 23 F.2d 531, 537 (D. Minn. 1924)).

445. *Id.* at 1667 in equity is warranted. If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority. *Winkelman et al. v. General Motors Corporation et al.*; *Kahn v. Same*, 39 F. Supp. 826, 833 (S.D.N.Y. 1940) (citing *Rogers v. Hill*, 289 U.S. 582, 591 (1933)). The *Winkelman* court found an investigation was warranted by trial, where salaries of \$100,000 per year were enhanced by bonuses of \$150,000 to \$400,000 per year. *Winkelman*, 39 F. Supp. at 834-835. As with *Marx*, however, *Winkelman* is almost exclusively cited within the Second Circuit for procedural matters.

446. *Baker*, 42 N.Y.S.2d at 167.

447. *Stearns v. Dudley*, 76 N.Y.S.2d 106 (1947), *aff'd*, 274 A.D. 1028 (N.Y. App. Div. 4th Dept. 1948).

448. *Id.* at 112.

449. *Id.* at 127-28.

directors and officers were ordered to repay compensation and bonuses.⁴⁵⁰ There, the bonus system should have been suspended after fire destruction of the company, but was continued into a questionable and lengthy liquidation.⁴⁵¹ Contrary precedent does exist, however. In *Epstein*,⁴⁵² a 1939 case, compensation was considered in relation to the services rendered in a claim involving corporate waste.⁴⁵³ The Court refused to substitute its judgment for that of the boards⁴⁵⁴ regarding the “conced[ingly]” large payments.⁴⁵⁵

4. *New York Blue Sky Provision, The Martin Act*

The *Fischbein*⁴⁵⁶ case was a claim of corporate waste involving a merger and acquisition.⁴⁵⁷ There, the acquiring entity paid high compensation to its executives prior to the merger closing.⁴⁵⁸ These facts are similar to BofA’s s Merrill acquisition.⁴⁵⁹ BofA relied on \$20 billion in federal government financing to take over Merrill for \$50 billion in September 2008.⁴⁶⁰ Merrill

450. *Id.* at 129-30 (note that although the opinion is focused on the directors who continued the compensation program, one executive also repaid money to the corporation).

451. *Id.* at 129.

452. *Epstein v. Schenck*, 35 N.Y.S.2d 969 (1939).

453. *Id.* at 977 (citing *Rogers*, 289 U.S. at 591-592). See also the *Gallin* factors:

To come within the rule of reason the compensation must be in proportion to the executive’s ability, services and time devoted to the company, difficulties involved, responsibilities assumed, success achieved, amounts under jurisdiction, corporation earnings, profits and prosperity, increase in volume or quality of business or both, and all other relevant facts and circumstances; nor should it be unfair to stockholders in unduly diminishing dividends properly payable.

Mann v. Luke 272 A.D. 19, 24-25 (N.Y. App. Div. 1st Dept. 1947) (citing *Gallin v. National City Bank*, 152 Misc. 679, 703 (1934)). See also *Heller v. Boylan*, 29 N.Y.S.2d 653 (1941), *aff’d*, 263 A.D. 815 (N.Y. App. Div. 1st Dept. 1941) (same principle, though as applied to bonuses). *Heller* has been represented as the modern approach to executive compensation. Kropp, *supra* note 343, at 31.

454. Though the court did discuss possible fraud in relation to the compensation, it found none and the discussion was not dispositive. *Epstein*, 33 N.Y.S.2d at 978-980. See also *Meyers v. Cowdin*, 47 N.Y.S.2d 471, 476-477 (1944), *aff’d*, 296 N.Y. 755 (N.Y. 1946). Although executive pay was increased each year over a period of years, the court did not find the increases “excessive [] or out of proportion to the value of the services performed.” *Meyers*, 47 N.Y.S.2d at 476. The court concluded that plaintiffs failed in that there was “no bad faith, collusion or illegality having been established.” *Meyers*, 47 N.Y.S.2d at 477. Alternatively, the discussion can also focus on directors approving their own pay increases. See *Godley v. Crandall & Godley Co.*, 212 N.Y. 121, 131-133 (N.Y. 1914) (found the directors acted in fraud and bad faith as regards diversion of corporate profits to their own compensation).

455. *Epstein*, 33 N.Y.S.2d at 977. Plaintiff-favorable settlements do occur, however. See *Diamond v. Davis*, 62 N.Y.S.2d 181, 185 (1945) (settlement modified the bonus system and its computation).

456. *Fischbein*, 721 N.Y.S.2d at 516.

457. *Id.*

458. *Id.* (the court affirmed the trial dismissal of the claim because the plaintiff had neither standing nor the appropriate pleading).

459. For information on the federal investigation into the matter, see generally Sarah O’Connor and Greg Farrell, *SEC to review whether BofA broke law*, FIN. TIMES, Apr. 14, 2009, available at http://www.ft.com/cms/s/0/d3bcd4c4-2878-11de-8dbf-00144feabdc0.html?ftcamp=rss&nclck_check=1; Zachary A. Goldfarb and Amit R. Paley, *SEC Reviewing Omission of Merrill Bonuses From Filing*, WASH. POST, Apr. 14, 2009, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/04/13/AR2009041302745.html?hpid=moreheadlines>.

460. Heidi N. Moore, Deal Journal, “Bank of America-Merrill Lynch: A \$50 Billion Deal From Hell”

had sustained losses of \$27.5 billion dollars in 2008.⁴⁶¹ Despite this record loss, Merrill paid \$3.6 billion dollars in bonus payments days before the companies merged.⁴⁶² In the Spring of 2009, it was alleged by BofA shareholders that they were not informed of the bonuses prior to voting on the merger.⁴⁶³ In response, BofA maintained it had no legal obligation to so inform its shareholders.⁴⁶⁴ The matter has generated several separate legal suits and investigations focusing on various issues.⁴⁶⁵ SEC Chairwoman Shapiro indicated in the Spring she was evaluating the matter.⁴⁶⁶ By summer,

WALL ST. J., Jan. 22, 2009, ¶¶ 1-2, <http://blogs.wsj.com/deals/2009/01/22/bank-of-america-merrill-lynch-a-50-billion-deal-from-hell/>.

461. O'Connor & Farrell, *supra* note 459 ¶ 6.

462. *Id.* ¶ 1.

463. *Id.*

464. *Id.* ¶ 3.

465. Apart from the various shareholder suits, the SEC has pursued litigation as well. SEC v. Bank of America Corp., Case No. 09 civ 6829 (S.D.N.Y. Filed Aug. 3, 2009). It is also widely rumored that the Federal Bureau of Investigation ("FBI") is working closely with the Department of Justice ("DOJ") to bring criminal charges against BofA actors. Rick Rothacker, *FBI Looking Into BofA-Merrill Deal*, CHARLOTTE OBSERVER, Sept. 18, 2009, available at <http://www.charlotteobserver.com/business/story/954477.html>. State actors are also pursuing BofA. In addition to New York Attorney General Cuomo, North Carolina Attorney General Cooper has also launched a formal investigation into the matter. Rick Rothacker, *N.C. Demands BofA's Records on Bonuses*, NEWS & OBSERVER, Feb. 6, 2009, available at <http://www.newsobserver.com/business/story/1395981.html>. Ohio Attorney General Richard Cordray has also filed litigation against Bank of America, as a member of a plaintiff's class action, and on behalf of several pension funds. *In re Bank of America Corp.*, Case No. 09 MDL 2058 (DC) (S.D.N.Y. Sept. 25, 2009), complaint available at <http://www.ohioattorneygeneral.gov/Briefing-Room/News-Releases/September-2009/Securities-Litigation-Briefing-Documents/Consolidated-Amended-Bank-of-America-Complaint>.

The BofA and Merrill merger has revealed competing legal issues for resolution. For example, in light of the defense BofA has pursued before Judge Rakoff of the S.D.N.Y., legal practitioners are questioning the parameters of the attorney client privilege and advice of counsel defense. See, e.g., Zach Lowe, *Did Bank of America Waive Attorney-Client Privilege in Merrill Bonus Flap?*, AMER. LAWYER, Aug. 26, 2009, available at <http://www.law.com/jsp/article.jsp?id=1202433336204&rss=newswire>. As another example, both federal and state agencies have publicly reported that a component of their investigation is to determine if the federal government unduly pressured BofA to proceed with the merger despite knowledge of Merrill's fourth quarter losses. See, e.g., Louise Story, *Congress Presses for Details From Bank of America on Talks*, N.Y. TIMES, Sept. 20, 2009, available at http://www.nytimes.com/2009/09/21/business/21bank.html?_r=2&adxnnl=1&adxnnlx=1253546944-lvJVLpkPNZ4ZX9BSzR2ew. Or, was it BofA who unduly pressured the federal government? See, e.g., Sue Reisinger, Corporate Counsel, *What Was BofA's Lawyer's Advice on Merrill? It Depended on the Audience*, LAW.COM, Oct. 26, 2009, http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202434896537&What_Was_BofA_Lawyers_Advice_on_Merrill_It_Depended_on_the_Audience=&rc=EMC-Email&et=editorial&bu=Corporate%20Counsel&pt=Corporate%20Counsel%20Daily%20Alerts&cn=cc20091024&kw=What%20Was%20BofA%20Lawyer. And of course, BofA is subject to a number of shareholder suits seeking remedy for alleged loss in shareholder value. See, e.g., *Bahnmaier v. Bank of America*, Case No. 09-CV-2099 JWL/DJW (D. Kan. Feb. 27, 2009) (complaint available at http://securities.stanford.edu/1042/BAC_01/2009227_o01c_092099.pdf).

BofA is also facing increased scrutiny by Congress. Louise Story, *Congress Presses for Details From Bank of America on Talks*, N.Y. TIMES, Sept. 20, 2009, available at http://www.nytimes.com/2009/09/21/business/21bank.html?_r=1&adxnnl=1&adxnnlx=1253546944-lvJVLpkPNZ4ZX9BSzR2ew. In particular, from the House Committee on Oversight and Reform and its Chairman Edolphus Towns (D - NY). *Id.*

466. Goldfarb and Paley, *supra* note 459, ¶ 6 (as to whether any federal securities laws were in fact violated).

moments before the SEC could file a complaint alleging *inter alia* misrepresentation regarding the Merrill bonuses, a settlement with BofA was reached in the amount of \$33 million.⁴⁶⁷ The settlement, however, was not approved by Judge Rakoff in the Southern District Court of New York.⁴⁶⁸ Through his multiple opinions on the matter, Judge Rakoff clearly communicated his disapproval of the settlement as unfair to shareholders.⁴⁶⁹ BofA continued the defense that it did nothing wrong, and that in fact the matter of the Merrill compensation was disclosed publicly via several sources.⁴⁷⁰ In January 2010 the SEC filed new and separate charges against BofA for misrepresentation of the Merrill losses.⁴⁷¹ A settlement between the SEC and BofA for \$150 million was ultimately reached and approved by Judge Rakoff in February 2010, concluding the agency's litigation.⁴⁷²

Attorney General Cuomo⁴⁷³ is also among those pursuing BofA regarding

467. SEC, Lit. Release No. 21164, <http://www.sec.gov/litigation/litreleases/2009/lr21164.htm> (Aug. 3, 2009).

468. Ross Todd, *Rakoff Wants More Briefing from BofA and SEC on Merrill Bonuses, Asks About Lawyers' Role in Drafting Proxy Statement*, AMLAW LITIGATION DAILY, Aug. 10, 2009, http://www.law.com/jsp/tal/digestTAL.jsp?id=1202432932461&Rakoff_Wants_More_Briefing_from_BofA_and_SEC_on_Merrill_Bonuses_Asked_About_Lawyers_Role_in_Drafting_Proxy_Statement.

469. Memorandum Order, SEC v. Bank of America, 09 Civ. 6829 (JSR) (Sept. 14, 2009) (among the key issues Judge Rakoff continues to press both parties before him, but which neither party has adequately been able to answer, is who in fact advised BofA how to structure the Merrill acquisition).

470. Reply Memorandum of Law on Behalf of Bank of America Corporation, SEC v. Bank of America, No. 09 Civ. 6829 (JSR) (Sept. 9, 2009). These other sources include a provision in the merger agreement to an undisclosed schedule. *Id.* The undisclosed schedule in fact did contain provisions regarding the Merrill bonuses. *Id.* BofA maintains the use of such undisclosed schedules is traditionally accepted party behavior in the context of an acquisition. *Id.* The other sources BofA alleges constituted disclosure includes media reports that discussed the Merrill bonuses and were contemporaneous to the proxy vote. *Id.* A recent Judge Rakoff ruling prohibits BofA presenting this evidence and argument at the March 1, 2010 trial. Opinion and Order, SEC v. Bank of America, No. 09 Civ. 6829 (JSR) (Jan. 4, 2010), available at <http://amlawdaily.typepad.com/BofAmediaruling.pdf>.

471. Dan Fitzpatrick & Sara Scannell, *BofA to Limit Curl's Duties; SEC Won't Sue Top Officers*, WALL ST. J., Jan. 12, 2010, available at <http://online.wsj.com/article/SB10001424052748704055104574652601305959222.html?mod=djemalertNEWS&mg=com-wsj>.

472. Judge Rakoff expressed dismay at the manner in which the Merrill bonuses and losses were disclosed, unsure if the manner of disclosure was the result of intent or negligence. Order and Opinion, *Securities and Exchange Commission v. Bank of America* 09 Civ. 6829, 10 Civ. 0215 (JSR) (S.D.N.Y. Feb. 22, 2010).

473. New York's Attorney General Cuomo is not the only state attorney general litigating matters involving executive compensation. Connecticut Attorney General Richard Blumenthal tried to block a newspaper publisher from rewarding executive bonuses of \$1.7 million in light of layoffs and Chapter 11 proceedings. Baldas, *supra* note 2, ¶ 8. Blumenthal was quoted saying the executive payout "illegally detracts from money owed to creditors like the state of Connecticut." *Attorney General Objects to Journal Register Newspaper Company's Bonus Plan*, ASSOC. PRESS. PENNSYLVANIA LOCAL NEWS, Mar. 4, 2009, ¶ 1, http://www.pennlive.com/midstate/index.ssf/2009/03/attorney_general_objects_to_jo.html. The Attorney General filed an objection to the executive payout in bankruptcy court. Assoc. Press, *State Attorney General Files Objection to Journal Register Execs' Bonuses*, ED. & PUBLISHER, Mar. 4, 2009, ¶ 1, available at http://www.editorandpublisher.com/eandp/news/article_display.jsp?vnu_content_id=1003947871. The compensation plan was approved in July 2009, however. Leonard Honeyman, *JRC Bankruptcy "Shutdown Bonuses" OK*, NEW HAVEN INDEPENDENT, July 8, 2009, available at <http://newhavenindependent.org/>

the Merrill matter and alleged fraud.⁴⁷⁴ The Attorney General has relied on one of New York's blue sky provisions, the Martin Act.⁴⁷⁵ The Martin Act gives the New York Attorney General broad powers to investigate and litigate financial fraud.⁴⁷⁶ The purpose of the act is to prevent any form of deception

archives/2009/07/jrc_gets_ok_to.php. Attorney General Blumenthal's office issued a press release that registered disappointment and indicated the court's decision would be reviewed to "determine whether further action [was] appropriate." Press Release, Conn. Attorney General's Office, Attorney General's Statement on Bankruptcy Court Ruling that Allows \$1.3 Million In Bonuses to Journal Register Company Executives, available at <http://www.ct.gov/AG/cwp/view.asp?A=2341&Q=443084> (July 8, 2009).

Attorney General Blumenthal has been a vocal opponent as regards large executive compensation packages and the New England utility industry. In 2008 Attorney General Blumenthal filed a motion for a hearing to protest compensation at ISO, a New England utility that oversees a regional power grid. Christopher Keating, Capitol Watch, *Blumenthal Rips High Executive Salaries at ISO*, HARTFORD COURANT, Dec. 4, 2008, http://blogs.courant.com/capitol_watch/2008/12/blumenthal-rips-high-executive.html. More recently, Attorney General Blumenthal publicly criticized the executive compensation paid by a Connecticut natural gas provider which is expected to layoff at two Connecticut subsidiaries. Eric Gershon, *Blumenthal Criticizes Energy East Payment to Recently Departed Exec*, HARTFORD COURANT, Dec. 4, 2009, available at <http://www.istockanalyst.com/article/viewStockNews/articleid/3686933>. Blumenthal is quoted, "[The] \$21.8 million paid to a single top executive—for leaving—is four times the amount necessary to keep all 67 employees essential to safe and reliable service." *Id.* The Attorney General has even gone so far as to indicate he will propose legislation to the Connecticut Legislature in 2010 that will limit executive and director pay at public utilities. Richard Blumenthal, *Taking An Aggressive Stand for Consumers*, CONN. LAW TRIBUNE, Jan. 4, 2010, available at <http://www.ctlawtribune.com/getarticle.aspx?ID=35926>.

474. Michael J. de la Merced, Dealbook, *BofA Sued by Cuomo, but Strikes Deal with SEC*, N.Y. TIMES, Feb. 4, 2010, available at <http://dealbook.blogs.nytimes.com/2010/02/04/bofa-agrees-to-150-million-settlement-in-sec-case/#lawsuit>.

475. Earlier this year, Attorney General Cuomo went to the Supreme Court in New York County in 2009 to compel former Merrill CEO John Thain to divulge who received the \$3.6 billion in bonuses. *New York v. John Thain*, 2009 NY Slip Op 29114 (table), 2009 N.Y. Misc. LEXIS 591 (2009) (court denied the third party's right to intervene). Thain ultimately provided the subpoenaed information to Cuomo, subject to a stipulation of confidentiality pending third party litigation to intervene. *Id.* at **2. The court found that part of the discretionary powers of the Attorney General under the Martin Act is to divulge the information gathered during his investigation. *Id.* at **8-9.

The Martin Act has also been used in claims of financial statement and reporting fraud. *Markewich v. Adikes*, 422 F. Supp. 1144, 1146 (E.D.N.Y. 1976) (the motion to dismiss the Martin Act claim was denied; no subsequent procedural history suggests the parties settled out of court).

Attorney General Cuomo relied on the Martin Act again in January 2010 to demand 2009 bonus pool information from eight companies that relied on taxpayer funds during the Fall of 2008 and Spring of 2009. See, e.g., Karen Freifeld, *N.Y.'s Cuomo Seeks Bonus Data From Bailed-Out Banks (Update 4)*, BUS. WEEK, Jan. 11, 2010, available at <http://www.businessweek.com/news/2010-01-11/new-york-s-cuomo-seeks-bonus-data-from-tarp-banks-update2-.html> (Jan. 11, 2010) (demands were made upon BofA and Goldman Sachs).

476. Nicholas Thompson, Legal Affairs, *The Sword of Spitzer*, LEGAL AFFAIRS, June 2004, ¶ 3, http://www.legalaffairs.org/issues/May-June-2004/feature_thompson_mayjun04.msp (June 2004). The Martin Act, Article 23-A, provides:

1. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to use or employ any of the following acts or practices:

(a) Any fraud, deception, concealment, suppression, false pretence or fictitious or pretended purchase or sale; ...

where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities or commodities, as defined in section three hundred fifty-two of this article, regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted.

related to securities.⁴⁷⁷ The Act gives the Attorney General discretion as to what matters to investigate, and provides power to subpoena witnesses and produce evidence.⁴⁷⁸

The Attorney General may have evaluated cases such as *Loengard*⁴⁷⁹ as his office progressed forward in the BofA matter. In *Loengard*, plaintiffs claimed that defendants—a parent and wholly-owned subsidiary involved in a short form merger⁴⁸⁰—acted fraudulently by not providing the minority shareholders with notice of the merger,⁴⁸¹ and by deflating the value of the plaintiffs' shares.⁴⁸² After lengthy litigation,⁴⁸³ the District Court found that plaintiffs failed to state a cause of action under the Martin Act for failure to show fraudulent conduct.⁴⁸⁴ The Court reasoned that fraudulent conduct under the Act was understood as a “‘tendency’ to deceive or mislead.”⁴⁸⁵ The Court did not find the appraisal of plaintiffs' shares fraudulent,⁴⁸⁶ or that the defendants had any duty under the law to provide the plaintiffs with notice of the merger.⁴⁸⁷ Prospectively, it should be noted that although the Martin Act was intended to be interpreted broadly,⁴⁸⁸ there exists no private right of action.⁴⁸⁹ Any litigation made pursuant to the Act must be initiated by the

N.Y. GEN. BUS. LAW §§ 352-c (2009). See also §§ 339-a, 352-353.

477.

The purpose of the [Act] is to prevent all kinds of fraud in connection with the sale of securities and commodities and to defeat all related schemes whereby the public is exploited, the terms “fraud” and “fraudulent practices” to be given a wide meaning so as to embrace all deceitful practices contrary to the plain rules of common honesty, including all acts, even though not originating in any actual evil design to perpetrate fraud or injury upon others, which do tend to deceive or mislead the purchasing public.

People v. Lexington Sixty-first Associates, 381 N.Y.S.2d 836, 840 (N.Y. 1976).

478. Thain, 2009 N.Y. Misc. LEXIS 591 at **1-2 (citing §§ 352(1-2)).

479. *Loengard v. Santa Fe Industries, Inc.*, 573 F. Supp. 1355 (S.D.N.Y. 1983), later proceeding, 639 F. Supp. 673 (S.D.N.Y. 1986). Though in all fairness, *Loengard* is cited by subsequent courts for holding that the statute of limitations is six years for Martin Act claims, and three years for fiduciary claims (See, e.g., *Grosso v. Radice*, 2009 U.S. Dist. LEXIS 21233 at *25 (E.D.N.Y. Mar. 16, 2009)).

480. *Id.* at 1356.

481. *Id.* at 1359; *Leongard v. Santa Fe Industries, Inc.*, 639 F. Supp. 673, 674 (S.D.N.Y. 1986) (“*Leongard II*”).

482. *Loengard*, 573 F. Supp. at 1359; *Leongard II*, 639 F. Supp. at 674.

483. *Leongard II*, 639 F. Supp. at 674 (previous decisions listed in n. 2).

484. *Id.* at 676-77.

485. *Id.* at 675 (emphasis in original).

486. *Id.* at 675-76.

487. *Id.* at 676. The court also destroyed plaintiffs' allegations that the merger was for a fraudulent purpose, as under Delaware law, a merger is proper if for the purpose of consolidating power or to simply become private. Still construing Delaware law, the court found the merger was completed in full compliance, and without any material misstatements or omissions. *Id.* at 677.

488. *N.Y. v. People v. Federated Radio*, 244 N.Y. 33, 38-40 (1926) (followed by *People v. Bradick*, 16 Misc. 2d 1080, 1081-1082 (1959)).

489. *Proposed Legislation Would Provide Private Right of Action for Certain Plaintiffs Under New York's Martin Act*, SECURITIES LAW UPDATE (Sidley Austin LLP), June 19, 2007, 3 n. 17, available at <http://www.sidley.com/files/News/ad373261-e9d9-43ef-b74b-04f29c308567/Presentation/NewsAttachment/ae098a6b-f507-4e45-87bd-009f5b417984/SecuritiesLaw607.pdf> (citing *Rego Park Gardens Owners Ass'n v. Rego Park Gardens Assoc.*, 595 N.Y.S.2d 492, 494 (2d Dep't 1993); *Pro Bono Invs. v. Gerry*, 2005 WL

Attorney General.⁴⁹⁰

At the time of authorship, Attorney General Cuomo's litigation against BofA and its executives was still pending.⁴⁹¹

5. *Common Law Action for Fraud*

It has been suggested that a common law action for fraud may be useful to recoup executive compensation in New York.⁴⁹² The rule was summarized in *Sterling*⁴⁹³ where the court affirmed that a plaintiff must allege "defendants made misrepresentations of material existing fact; which were false and known to be false by the defendants when made, for the purpose of inducing plaintiffs' reliance; justifiable reliance on the alleged misrepresentation or omission by the plaintiffs; and injury [sic]."⁴⁹⁴ "In addition, 3016(b) requires that the complaint set forth the misconduct complained of in sufficient detail to clearly inform each defendant of what their respective roles were in the incidents complained of."⁴⁹⁵

6. *Unjust Enrichment*

Unjust enrichment has also been proposed as a theory for aggrieved plaintiffs.⁴⁹⁶ Plaintiffs must "assert [] that a benefit was bestowed . . . by plaintiffs and that defendants will obtain such benefit without adequately compensating plaintiffs," particularly where the defendants have clearly benefited, and "equity and good conscience require that they make restitution."⁴⁹⁷ "The receipt of a benefit alone," however, "is insufficient to

2429787, 16 (S.D.N.Y. 2005); *CPC Int'l Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 276 (N.Y. 1987)).

490. *Id.* It should also be noted that New York courts show deference to federal precedent when dealing with Martin Act claims. *New York v. Clark E. McLeod*, 819 N.Y.S.2d 213 (2006) (*citing* All Seasons Resorts, Inc. v. Abrams, 68 N.Y.2d 81, 87 (1986); *People v. First Meridian Planning Corp.*, 201 A.D.2d 145 (3d Dept. 1994)).

491. Adam O'Daniel, *Former Bank of America CEO Ken Lewis Rejects Offer to Settle Fraud Charges*, CHARLOTTE BUS. J., Mar. 31, 2010, http://www.bizjournals.com/charlotte/blog/bank_notes/2010/03/report_former_bank_of_america_ceo_ken_lewis_rejects_offer_to_settle_fraud_charges.html.

492. *Id.* at 3 n. 18 (*citing* *Sterling Nat'l Bank v. The Park Ave. Branch*, 2006 N.Y. Misc. LEXIS 2888 (2006)). The suggestion was made as an alternative to inducing the New York state government to use the Martin Act to litigate violations. *Id.* Conceivably, however, if an attorney general could use the Martin Act to investigate bonuses, a plaintiff could then use common law fraud regarding stock option grants and backdating, where proxies are involved. *See supra* text discussion at 44 (Martin Act used to investigate bonuses), 26-34 (stock option grants, backdating, and proxies).

493. *Sterling*, 2006 N.Y. Misc. LEXIS 2888.

494. *Id.* at *13 (*citing* *Lama Holding Company v. Smith Barney, Inc.*, 88 N.Y.2d 413 (1996); *New York University v. Continental Ins. Co.*, 87 N.Y.2d 308, 318 (1995); *Friedman v. Anderson*, 23 A.D.3d 163, 166 (N.Y. App. Div. 1st Dept. 2005)).

495. *Id.* (*discussing* N.Y. C.P.L.R. 3016(b) (McKinney 2006)).

496. *New York v. McLeod*, 819 N.Y.S.2d 213, *15 (2006) (table), 2006 N.Y. Misc. LEXIS 1227 at *15 (*citing* Wiener, 241 A.D.2d at 120). *See also supra* note 409 (New York Attorney General claim four against Richard Grasso contained restitution language based on unjust enrichment).

497. *Korff v. Corbett*, 18 A.D.3d 248, 251 (N.Y. App. Div. 1st Dept. 2005) (*citing* *Wiener v. Lazard*

establish a cause of action.”⁴⁹⁸

7. *Duty to Corporate Creditors*

Aggrieved shareholders aside, wronged creditors may have claims regarding executive compensation. Directors owe a duty of faithful conduct to corporate creditors.⁴⁹⁹ Creditors are in fact empowered by statute to pursue both directors and officers for misconduct.⁵⁰⁰ In New York, directors and officers of an insolvent corporation can be considered trustees of its assets on behalf of the creditors.⁵⁰¹ An action to enforce this fiduciary duty precludes the directors and officers from placing their interests ahead of the creditors.⁵⁰²

8. *Fraudulent Conveyance*

Creditor rights might also be pursued under fraudulent conveyance principles in New York’s Uniform Fraudulent Conveyance Act, codified by statute in Article 10 of New York’s Debtor and Creditor Law.⁵⁰³ Actions can be brought only by creditors,⁵⁰⁴ against the transferee or beneficiaries,⁵⁰⁵ and amounts sought to be recovered are limited to the amount alleged to be improperly transferred.⁵⁰⁶ Attorney General Cuomo in 2008 effectively leveraged the threat of a fraudulent conveyance action against American International Group (“AIG”), securing AIG’s agreement to freeze salaries and eliminate bonuses for high-level officers.⁵⁰⁷ Cuomo continued to use the threat

Freres & Co., 241 A.D.2d 114, 119 (1998).

498. McLeod, 819 N.Y.S.2d at *15 (citing Wiener, 241 A.D.2d at 120).

499. People v. Marcus, 261 N.Y. 268 (1933) (followed by People v. Calandra, 164 A.D.2d 638 (N.Y. App. Div. 1st Dept. 1991)).

500. N.Y. BUS CORP LAW § 720(b) (McKinney 2009) provides:

“An action may be brought for the relief provided in this section, and in paragraph (a) of section 719 (Liability of directors in certain cases) by a corporation, or a receiver, trustee in bankruptcy, officer, director or judgment creditor thereof, or, under section 626 (Shareholders’ derivative action brought in the right of the corporation to procure a judgment in its favor), by a shareholder, voting trust certificate holder, or the owner of a beneficial interest in shares thereof.”

501. New York Credit Men’s Adjustment Bureau v. Weiss, 278 A.D. 501 (N.Y. App. Div. 1st Dept. 1951), *aff’d*, 305 N.Y. 1 (1953); *see also* Heimbinder v. Berkovitz, 175 Misc. 2d 808, 816 (1998), *judgment modified on other grounds*, 263 A.D.2d 466 (N.Y. App. Div. 2d Dept. 1999).

502. Studley v. Lefrak, 66 A.D.2d 208, 213 (N.Y. App. Div. 2d Dept. 1979) (“transfer of all of the assets of a corporation to a sole stockholder or to a corporation controlled by the stockholder may be set aside when made in derogation of the rights of creditors”). *aff’d*, 48 N.Y.2d 954 (1979); *cf. In re Banister*, 737 F.2d 225, 228-229 (2d. Cir. 1984) (breach of fiduciary duty can occur when directors and officers benefit personally at creditors’ expense).

503. Brenner v. Philips, Appel & Walden, Inc., 1997 U.S. Dist. LEXIS 11539 at **9-10 (S.D.N.Y. 1997) (citing N.Y. Fraudulent Conveyance Act §§ 270-281 (1997)).

504. Geren v. Quantum Chemical Corp., 1995 U.S. App. LEXIS 39912 at *4 (2d Cir. 1995) (citing N.Y. DEBT. & CRED. LAW § 273 (McKinney 1993)).

505. Brenner, 1997 U.S. Dist. LEXIS 11539 at *14 (citing FDIC v. Porco, 75 N.Y.2d 840, 842 (1990)).

506. Fofas v. Leventhal, 1995 U.S. Dist. LEXIS 7641, **9-10 (S.D.N.Y. 1995).

507. Kevin LaCroix, *Bailouts, Bonuses and Clawbacks*, D&O DIARY, Jan. 30, 2009, ¶ 13, <http://www.dandodiary.com/2009/01/articles/corporate-governance/bailouts-bonuses-and-clawbacks/> (citing

of fraudulent conveyance against AIG, and recently subpoenaed the names of those who received bonuses in March of 2009,⁵⁰⁸ as well as information on who negotiated their compensation.⁵⁰⁹ In March 2009, public outcry resulted in fifteen of the top twenty bonus recipients voluntarily forfeiting their bonuses to AIG.⁵¹⁰ These repayments have not stymied the “moral outrage,”⁵¹¹ and a derivatives suit was filed in April of 2009 in California State Court against current CEO Edward Liddy, and various other Directors and Officers.⁵¹² The complaint alleges “no rational business purpose or justification” for the high executive compensation, particularly in light of the companies performance and financial condition.⁵¹³ The pleadings allege corporate waste, breach of fiduciary duty, abuse of control, and unjust enrichment.⁵¹⁴

A. DELAWARE STATE

The directors of a Delaware corporation have the authority and discretion to make executive compensation decisions.⁵¹⁵ It is the essence of business judgment⁵¹⁶ for an independent and informed Board, acting in good faith, to determine if “a particular individual warrant[s] large amounts of money,

Jonathan D. Glater & Vikas Bajaj, *Cuomo Seeks Recovery of Bonuses at A.I.G.*, N.Y. TIMES, Oct. 15, 2008, http://www.nytimes.com/2008/10/16/business/16pay.html?_r=2&ref=business (discussing the attorney general's letter and providing an active link to review it)).

508. Recall, AIG received \$85 billion in U.S. federal funds to avoid bankruptcy in September of 2008. David Cutler, *TIMELINE: AIG Developments Since U.S. Rescue*, REUTERS UK, Apr. 17, 2009, available at <http://uk.reuters.com/article/innovationNews/idUKTRE53G46U20090417?pageNumber=1&virtualBrandChannel=0>. Plans to make \$30 billion more available to AIG were announced in March of 2009. *Id.* It was publicly discovered as this time that AIG was under pre-existing contractual obligations to pay \$ 165 million dollars in retention payments by March 15, 2009.

509. Andrew Ross Sorkin, *Deal Book, Cuomo Seeks A.I.G. Bonus Information*, N.Y. TIMES, Mar. 16, 2009, ¶ 4, available at <http://dealbook.blogs.nytimes.com/2009/03/16/cuomo-seeks-aig-bonus-information/>.

510. Cutler, *supra* note 508, at 3. Although the bonuses are apparently being returned far more slowly than was originally anticipated. See, e.g., Brady Dennis, *AIG Executives' Promise to Return Bonuses Have Largely Gone Unfulfilled*, WASH. POST, Dec. 23, 2009, <http://www.washingtonpost.com/wp-dyn/content/article/2009/12/22/AR2009122203788.html>.

511. Kevin LaCroix, *Executive Compensation: The New Front Line in the Litigation Wars?*, D&O DIARY, Apr. 8, 2009, ¶ 1, <http://www.dandodiary.com/2009/04/articles/corporate-governance/executive-compensation-the-new-front-line-in-the-litigation-wars/>.

512. *Id.* at ¶ 3 (discussing AIG v. Liddy, et al., Civil Action No.: BC410879 (Apr. 1, 2009)). *Complaint available at* http://www.cpmlegal.com/pdf/AIG_Bonus_Complaint.pdf.

513. *Id.*

514. *Id.*

515. *In Re Citigroup Inc. Shareholder Deriv. Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009). The Delaware General Corporation Law grants every corporation the power to pay or otherwise provide officers and agents of the business with suitable compensation. DEL. CODE ANN. tit. 8, § 122(5) (2009).

516. The business judgment rule is a presumption which protects directors from liability so long as in making the decision, the directors “acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). The presumption can be rebutted if the plaintiffs show that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith. If that is shown, the burden shifts to the director defendants to demonstrate that the challenged act was entirely fair to the corporation and its shareholders. *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000).

whether in the form of current salary or severance provisions.”⁵¹⁷ Courts thus generally decline to pass judgment on what constitutes reasonable compensation.⁵¹⁸ Under Delaware law, however, director discretion in setting executive compensation is not unlimited. Indeed, the Delaware Supreme Court stated that “there is an outer limit” to the Board’s discretion, “at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste.”⁵¹⁹

1. *Seeking Recoupment of Executive Pay: Breach of Fiduciary Duty, Waste*

In common law actions the typical way for shareholders to seek to recoup excessive pay from executives of Delaware corporations is to claim that the corporate directors breached their fiduciary duties and that the approved payments constituted corporate waste.⁵²⁰ Plaintiffs may claim that the directors breached their fiduciary duty of due care⁵²¹ and/or their fiduciary duty of loyalty⁵²² (the latter encompassing the duty of good faith).⁵²³ The due care claim is more difficult for plaintiffs to establish because of the substantial protections afforded by the Delaware courts to directors under the business judgment rule, and because the vast majority of Delaware corporations eliminate or limit their directors’ personal liability to the corporation or stockholders for money damages for breaches of the duty of care.⁵²⁴ Plaintiffs

517. *Grimes v. Donald*, 673 A.2d 1207, 1215 (Del. 1996).

518. *Brehm v. Eisner*, 731 A.2d 342, 350 (Del. Ch. 1998).

“Sufficient consideration to the corporation may be, *inter alia*, the retention of the services of an employee, or the gaining of the services of a new employee, provided there is a reasonable relationship between the value of the services to be rendered by the employee and the value of the options granted as an inducement or compensation.” *Kerbs v. California E. Airways*, 90 A.2d 652, 656 (Del. 1952).

519. *Brehm*, 746 A.2d at 262 n.56 (Del. 2000) (citing *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962)).

520. *In Re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 697 (Del. Ch. 2005). The most notable case in which plaintiff shareholders made these claims was the long-running dispute over the lavish severance package paid to Michael Ovitz after he was terminated as President of The Walt Disney Company after serving for little over a year.

521. The fiduciary duty of due care requires that directors “use that amount of care which ordinarily careful and prudent men would use in similar circumstances.” *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963). Directors must also “consider all material information reasonably available” in making business decisions. *Brehm*, 746 A.2d at 259. Shortcomings in the directors’ process are actionable only if the directors’ actions are grossly negligent.

522. The fiduciary duty of loyalty “mandates that the best interest of the corporation and its shareholders take [] precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.” *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (citing *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984)).

523. Until the Delaware Supreme Court decided *Stone v. Ritter* in 2006, there was much discussion among the bar, the courts and academics whether the duty of good faith was a fiduciary duty separate and in addition to the fiduciary duties of care and loyalty, or whether the duty of good faith was subsumed under the fiduciary duty of loyalty. *In Re Walt Disney Co. Deriv. Litig.*, 907 A.2d at 745. The Supreme Court clarified that the duty of good faith is a component of the duty of loyalty. *Stone v. Ritter*, 911 A.2d 362, 269-70 (Del. 2006).

524. The Delaware General Corporation Law allows a Delaware corporation to include in its certificate of incorporation a provision eliminating or limiting the personal liability of a director for monetary damages for breach of fiduciary duty, except: for breach of the duty of loyalty, for acts or omissions not in good faith or

have been successful in recouping executive compensation by demonstrating a breach of the duty of loyalty where self-interested transactions occur.⁵²⁵ In such cases, the business judgment rule does not apply, and the burden shifts to the defendants to prove that the challenged transaction was entirely fair to the corporation.⁵²⁶ A third basis for recouping executive pay, that the payout amounted to waste, involves an onerous standard for plaintiffs.⁵²⁷ As the following cases illustrate, the Delaware courts are vigilant about self-dealing; but disinterested directors, even where conduct falls significantly short of corporate governance best practices,⁵²⁸ who approve lucrative payouts to officers, will not be held liable if they exercise their duties of due care and good faith.

2. *The Disney Case: Claims for Breach of Fiduciary Duty, Waste*

In the much discussed *Walt Disney Company Derivative Litigation*, the plaintiffs of the Walt Disney Company ("Disney") brought a derivative action against the Disney directors for breach of their fiduciary duties for blindly approving an employment agreement with Michael Ovitz, President of Disney, and for ultimately approving Ovitz's no-fault termination and the resulting severance payment of approximately \$130 million to 140 million⁵²⁹ made pursuant to the employment agreement.⁵³⁰ The plaintiffs contended that the Disney directors' actions constituted a breach of their fiduciary duties to act with due care and in good faith; and that even if the directors' actions were protected by the business judgment rule, the payout to Ovitz amounted to corporate waste.⁵³¹ The plaintiffs sought rescission and/or money damages from the Disney directors and Ovitz and disgorgement of Ovitz's unjust enrichment.⁵³² However, the Court of Chancery determined, and the Supreme

which involve intentional misconduct or a knowing violation of the law, or for any transaction from which the director derived an improper personal benefit. DEL. CODE ANN. tit. 8, § 102(b)(7) (2009).

525. See *infra* note 551, *Valeant Pharms. Int'l*, 921 A.2d 732, 745 (Del. Ch. 2007); *Julian v. E. States Constr. Serv., Inc.*, 2008 WL 267330 (Del. Ch.).

526. *In Re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693 at 756-57. Additionally, Delaware law does not allow corporations to limit liability for breaches of the duty of loyalty. See *supra* note 524.

527. *In Re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693 at 748.

528. Chancellor Chandler, in his 2005 decision following trial, stated that "there are many aspects of defendants' conduct that fell significantly short of the best practices of ideal corporate governance," but that "[u]nlike ideals of corporate governance, a fiduciary's duties do not change over time." *Id.* at 697.

529. The plaintiff shareholders' original complaint computed the value of the severance package at \$140 million, *Brehm*, 746 A.2d at 253. The Supreme Court approximated the value of the package at \$130 million. *In Re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 35 (Del. 2006).

530. *In Re Walt Disney Co. Deriv. Litig.*, 825 A.2d 275, 277 (Del. Ch. 2003).

531. *In Re Walt Disney Co. Deriv. Litig.*, 906 A.2d at 46-47. The claim for waste is rooted in the doctrine adopted by the Delaware courts that a plaintiff who fails to rebut the presumptions of the business judgment rule is not entitled to any remedy unless the transaction constitutes waste. *In Re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693 at 747.

532. *In Re Walt Disney Co. Deriv. Litig.*, 825 A.2d at 278. On appeal from the Chancellor's decision for the defendants after the 2004-2005 bench trial, the plaintiffs did not contend that the Disney defendants were

Court affirmed, that the challenged actions of the Disney defendants were protected business judgments, did not involve breach of fiduciary duty,⁵³³ nor did it constitute corporate waste.⁵³⁴

The Chancellor held that in agreeing to the key terms of Ovitz's employment agreement, the directors acted in good faith and believed that they were acting in the best interests of the company. He further held that the plaintiffs failed to meet their burden to demonstrate that the directors acted in a grossly negligent manner or that they failed to inform themselves of all material information reasonably available when making a decision.⁵³⁵ Similarly, with respect to Ovitz's no-fault termination and the payout of the severance package, the Court ruled that the Disney defendants did not breach their fiduciary duties nor act in bad faith.⁵³⁶ The board did not need to formally terminate Ovitz because the Company's governing instruments granted the Chairman/CEO, Michael Eisner, the right to unilaterally terminate inferior officers, and the board was informed of and supported Eisner's decision.⁵³⁷ Similarly, the board did not need to approve the payout of Ovitz's severance package because the board had delegated to the compensation committee the responsibility to approve compensation for Ovitz, and the committee's approval of Ovitz's compensation package included approval of the severance package.⁵³⁸

It is very rare for Delaware courts to make a finding of corporate waste, even in cases which challenge lavish payouts of executive compensation.⁵³⁹ To prevail on a claim for waste, the plaintiff must prove that the defendant authorized "an exchange that is so one sided that no business person of

directly liable as a result of their breach of fiduciary duties. Rather, plaintiffs argued that the Disney defendants' breach of fiduciary duties deprived them of the protections of the business judgment rule, and required the defendants to prove that their acts were entirely fair to Disney. In *Re Walt Disney Co. Deriv. Litig.*, 906 A.2d at 46. The plaintiffs apparently structured their argument this way because the Disney Certificate of Incorporation contained a provision that precluded monetary damages against Disney directors for breaches of the duty of care. *Id.* at 46, n37.

533. *Id.* at 73. As a result of this ruling, the Supreme Court did not need to consider plaintiffs' argument that the Disney defendants needed to prove that the severance payments to Ovitz were entirely fair.

534. *Id.* at 75.

535. *In Re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693 at 772.

536. *Id.* at 776.

537. *Id.* at 775-77.

538. *Id.* (affirmed in *In Re Walt Disney Co. Deriv. Litig.*, 906 A.2d at 69-70.)

539. *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d at 748. However, in the ongoing Citigroup shareholder derivative litigation, the court denied the defendants' motion to dismiss plaintiffs' claim for waste in approving the retiring CEO's compensation package. The company, pursuant to a letter agreement, paid out \$68 million to the former CEO, including bonus, salary, and accumulated stockholdings. Additionally, he was provided with an office, an administrative assistant, and a car and driver. In return, the retiring CEO contracted to sign a non-compete agreement, a non-disparagement agreement, a non-solicitation agreement, and a release of claims against the company. The Chancellor noted that he was left with very little information regarding (1) how much additional compensation the former CEO actually received as a result of the letter agreement and (2) the real value, if any, of the various promises given by the former CEO. Without more information and taking plaintiffs' well-pleaded allegations as true, the Chancellor concluded that there was reasonable doubt as to whether the letter agreement constituted waste. *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d at 138.

ordinary, sound judgment could conclude that the corporation has received adequate consideration.”⁵⁴⁰ In other words, waste is a rare, “unconscionable case where directors irrationally squander or give away corporate assets.”⁵⁴¹

The Supreme Court in *Disney* concluded that the plaintiffs’ claim for waste did “not come close” to meeting the “high hurdle” required to prove corporate waste.⁵⁴² The plaintiffs argued that the no-fault termination provisions in Ovitz’s employment agreement were wasteful because they provided Ovitz with an incentive to perform poorly as Disney’s President; and thus be eligible to receive the lavish severance package provided for in his employment agreement.⁵⁴³ The Supreme Court noted that the challenge of a severance payment made pursuant to an employment agreement under a waste claim, without more, is meritless when a company is contractually obligated to make the payments.⁵⁴⁴ The only way that the payment of a contractually obligated amount can constitute waste is if the contractual obligation itself is wasteful.⁵⁴⁵ The Supreme Court held that Disney’s contractual obligations were not wasteful because the no-fault provisions in Ovitz’s employment agreement had the rational business purpose of inducing Ovitz to leave his previous job, at which he earned tens of millions annually.⁵⁴⁶ The Chancellor of the Trial Court further found it unreasonable to assume that Ovitz intended to perform just poorly enough to be fired quickly and thus be eligible for the severance package but not so poorly that he could be terminated for cause and thus not be eligible for his lavish payout.⁵⁴⁷ Moreover, the Chancellor found that there was no indication that Ovitz brought anything less than his best efforts to the company, that there was credible evidence that the company would be better off without Ovitz, and that given his performance, Ovitz could not be fired for cause.⁵⁴⁸ Thus plaintiffs did not meet the stringent requirements of the waste test, and the payment of Ovitz’s severance package did not constitute waste.⁵⁴⁹

3. *Seeking Recoupment of Executive Pay: Self-Interested Transactions*

Plaintiffs in Delaware courts have had far more success in recouping executive pay where directors or officers pay themselves salary or bonus

540. *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000). In another formulation of the test to prevail on corporate waste: “the plaintiff must overcome the general presumption of good faith by showing that the board’s decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation’s best interests.” *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001).

541. *Brehm*, 746 A.2d at 263.

542. *In Re Walt Disney Co. Deriv. Litig.*, 906 A.2d at 75.

543. *Id.* at 74.

544. *Id.*

545. *Id.*

546. *Id.* at 75.

547. *In Re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693 at 759.

548. *Id.*

549. *Id.*

without the approval of an independent compensation committee. Directors who stand on both sides of a transaction have “the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.”⁵⁵⁰ Self-interested compensation decisions made without independent protections are subject to this same entire fairness standard.⁵⁵¹ The two components of entire fairness are fair dealing and fair price.⁵⁵² Fair dealing “embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.”⁵⁵³ Fair price “assures the transaction was substantively fair by examining ‘the economic and financial considerations.’”⁵⁵⁴

In a Delaware case concerning a plaintiff challenging the payout to a director who fixed his own compensation, the Court imposed upon the recipient the burden of showing the reasonableness of his compensation.⁵⁵⁵ In determining whether the defendant’s compensation was reasonable, the Court in that case listed numerous relevant factors, including: what other similarly situated executives received; the ability of the executive; to what extent the Internal Revenue Service (“IRS”) allowed the corporation to deduct the salary; whether the salary bore a reasonable relation to the success of the corporation; the amount previously received as salary; whether increases in salary were geared to increases in the value of services rendered; and the amount of the challenged salary compared to other salaries paid by the employer.⁵⁵⁶ The Court concluded that the defendant failed to meet his burden of demonstrating reasonableness since he failed to produce substantial evidence as to what other executives in the industry earn, and there was doubt as to whether defendant’s work was as essential and productive as he contended. The defendant also raised his own pay three-fold in the span of five years even though the earnings of the company rose only by approximately 79 percent in that time span.⁵⁵⁷

550. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983). Such directors “are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.”

551. *Valeant Pharm. Int’l v. Jerney*, 921 A.2d 732, 745 (Del. Ch. 2007). On the other hand, where an independent compensation committee sets director compensation, the courts do not apply the entire fairness standard. *Id.* at 746. Similarly, a self-interested transaction that is approved by a committee of disinterested directors potentially brings the transaction within the scope of the business judgment rule. DEL. CODE ANN., tit. 8, § 144(a)(1) (2009). Alternatively, a self-interested transaction may be ratified by a fully informed majority vote of the disinterested stockholders. *Id.* at § 144(a)(2).

552. *Weinberger*, 457 A.2d at 711. The two components of the entire fairness standard are not independent. Rather, “the fair dealing prong informs the court as to the fairness of the price obtained through that process. The court does not focus on the components individually, but determines entire fairness based on all aspects of the entire transaction.” *Valeant Pharm.*, 921 A.2d at 746.

553. *Weinberger*, 457 A.2d at 711.

554. *Valeant Pharms.*, 921 A.2d at 746 (quoting *Weinberger*, 457 A.2d at 711).

555. *Wilderman v. Wilderman*, 315 A.2d 610, 615 (Del. Ch. 1974). This case from 1974 was decided before the more recent development by the Delaware courts of the entire fairness standard for self-interested transactions.

556. *Id.* at 615.

557. *Id.*

The Court did concede that the defendant's services to the corporation appeared to have been important to its success; and, taking into account that the business had twenty employees and that the company's profits rose during the contested pay period, the Court allowed for compensation in excess of an amount suggested by an expert witness but less than the amount considered appropriate by the IRS.⁵⁵⁸ The Court ordered the defendant to return the excess compensation to the corporate treasury with interest.⁵⁵⁹

In a more recent Delaware case, the Court ordered a former director/president of a corporation to disgorge his entire bonus after the directors and executives decided to pay themselves large amounts in connection with a proposed initial public offering and spin-off of the company's most valuable asset.⁵⁶⁰ In that case, the payouts were approved by a compensation committee which was "clearly and substantially interested in the transaction they were asked to consider."⁵⁶¹ Thus, even the defendant conceded that he bore the burden of proving that the transaction was entirely fair.⁵⁶² In analyzing the fair dealing prong of the "entire fairness test," the Court determined that the process for determining bonuses was dominated by the company's chairman/CEO who predetermined the size of the bonus pool that was later justified by the compensation committee.⁵⁶³ In concluding that the process was unfair, the Court noted that the challenged transaction was initiated by management, and was structured, without negotiation, so that everyone would receive a bonus.⁵⁶⁴ Also key was that the relevant parties, including the Board, the compensation committee and the outside experts, relied on inflated and misleading information provided by management.⁵⁶⁵ The Court further held that while management did occasionally receive bonuses in connection with extraordinary activities, the sort of event in the given case did not justify such substantial additional bonuses, which amounted to 2 percent of the total value of the spin-off.⁵⁶⁶ As further support that the bonus payments were unfair, the Court noted that the transaction involved merely a restructuring of the biggest and most valuable asset of an already public company into a different public company.⁵⁶⁷ Moreover, management of the parent company was to have no further involvement in the spun

558. *Id.* at 615-16.

559. *Id.*

560. *Valeant Pharm.*, 921 A.2d at 735-36.

561. *Id.* at 739.

562. *Id.* at 744.

563. *Id.* at 746-47.

564. *Id.* at 748.

565. *Id.* (The court's finding that the process was unfair does not end its inquiry because the transaction could be deemed entirely fair if the defendant proves that the price was fair. However, unless the price can be justified by reference to reliable markets or substantial and dependable comparable transactions, the burden for proving fair price would be "exceptionally difficult.")

566. *Id.* at 749-50.

567. *Id.* at 750. (An outside expert opined that a 2 percent award might be appropriate in a smaller transaction, such as an incubator IPO or spin-off of a small division of a larger company.)

company.⁵⁶⁸ In sum, the Court held that the price terms of the bonuses could not be justified by reference to any reliable market, and there was no proof of substantial comparable transactions to provide support for the size of the bonuses.⁵⁶⁹

Where a court determines that a self-dealing transaction is unfair, the transaction is voidable as between the parties.⁵⁷⁰ Additionally, the underlying breach of the fiduciary duty of loyalty can give rise to other damages, including incidental damages.⁵⁷¹ The Court in *Valeant* held that the defendant had to disgorge his entire \$3 million bonus as part of a voidable-transaction.⁵⁷² The defendant was also ordered to return his pro-rata share of the bonuses paid to non-directors⁵⁷³ and his pro-rata share of fees and expenses of the special litigation committee.⁵⁷⁴

B. OTHER NOTABLE STATE POSITIONS: SCRUSHY V. TUCKER

In a 2006 decision, the Alabama Supreme Court held in *Scrushy v. Tucker* that the former CEO of a publicly traded corporation involved in an accounting scandal was unjustly enriched⁵⁷⁵ by the payment of \$47 million in bonuses, and

568. *Id.*

569. *Id.* In another recent Delaware case, *Julian v. E. States Constr. Service, Inc.*, directors awarded themselves substantial bonuses. The directors thus had the burden to prove that the payments were entirely fair. Three brothers owned shares in closely-held corporations when one brother announced his retirement. The court held that the payout of the bonuses resulted from an unfair process. Just eleven days after the brother submitted his letter of retirement, the Board of one of the corporations, composed of the other two brothers and a third man, approved the bonuses after discussing the concept for fifteen minutes and consulting no outside experts. The court also held that the price was unfair. The size of the bonuses greatly exceeded any prior awards. The challenged bonuses represented 22.28% of adjusted income while bonuses in previous years constituted approximately 3.3% of adjusted income. The court also noted that the bonuses decreased the net book value of the corporation, thus reducing the value of the shares that the retiring brother would have to sell back to the corporation. *supra* note 525 at *1, *18, *19.

570. *Valeant Pharms.*, 921 A.2d at 752.

571. *Id.* In another formulation of the available remedies when a transaction fails the entire fairness standard, a court may fashion any form of equitable and monetary relief as may be appropriate. *Weinberger*, 457 A.2d at 714.

572. *Valeant Pharms.*, 921 A.2d at 752. (The court refused the defendant's request to allow him to keep the portion of the bonus that the court deemed "fair" and return the excess. The court also noted that there was no suggestion that the return of the defendant's bonus would unjustly enrich the company.) the court ordered the defendants to disgorge the bonuses and return them with interest to the company. *Supra* note 569 at 19.

573. *Valeant Pharms.*, 921 A.2d at 754. (The company did not seek the return of the bonuses paid to the non-director employees. Rather, the company sought to recover the defendant's pro-rata share of the bonuses paid to non-directors.)

574. *Id.* (Delaware law allows for the recovery of special litigation committee expenses for a breach of fiduciary duty when the plaintiff corporation prevails in court and the special litigation committee expenses were necessary to prosecute the suit.)

575. The Delaware Supreme Court explained the theories of restitution and unjust enrichment as follows:

For a court to order restitution it must first find the defendant was unjustly enriched at the expense of the plaintiff. "Unjust enrichment is defined as 'the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience.'"

Fleer Corp. v. Topps Chewing Gum, Inc., 539 A.2d 1060, 1062 (Del. 1988) (*quoting* 66 Am.Jur.2d Restitution

ordered him to repay the gross amount of the bonuses.⁵⁷⁶ In separate proceedings, fifteen senior executives of the corporation, HealthSouth, pled guilty to various criminal acts, including falsifying and fabricating the corporation's financial statements.⁵⁷⁷ The former CEO and defendant in *Scrushy*, Richard Scrushy, was acquitted in an earlier proceeding of any criminal wrongdoing.⁵⁷⁸ The parties in *Scrushy* stipulated that Scrushy was not responsible for the falsification of the company's financial statements, and Scrushy did not dispute that the original financial statements were inaccurate and unreliable.⁵⁷⁹ Scrushy, however, argued that he was entitled to keep his bonus payments because his employment agreement with HealthSouth obligated the company to pay him annual target bonuses.⁵⁸⁰ The Court decided that the defendant's employment agreement merely gave him "the opportunity to earn an annual target bonus," but that the company's disclosure in its annual proxy on Form 14A precluded the payment of bonuses because the company sustained annual net losses.⁵⁸¹ The company's annual proxy provided that no bonuses would be paid unless annual net income exceeded budgeted net income.⁵⁸² Since the company did not have net income during the years in question, Scrushy did not have the opportunity to earn target bonuses pursuant to his employment agreement, and the company was not contractually obligated to pay bonuses.⁵⁸³

The Court concluded that under the law of either Delaware or Alabama, equity and good conscience required restitution in the form of the repayment of the bonuses because the payments were made as a result of the vast accounting fraud perpetrated upon HealthSouth and its shareholders.⁵⁸⁴ The Court noted that as a manager of HealthSouth, Scrushy was responsible for the filing of accurate financial statements, and he did not fulfill those responsibilities adequately.⁵⁸⁵ The Court stated that it would have been unconscionable to allow Scrushy to keep millions of dollars at the expense of the corporation to which he owed a fiduciary duty.⁵⁸⁶

and Implied Contracts § 3, 945 (1973)). To obtain restitution, the plaintiffs were required to show that the defendants were unjustly enriched, that the defendants secured a benefit, and that it would be unconscionable to allow them to retain that benefit. *Id.* at 1063. Restitution is permitted even when the defendant retaining the benefit is not a wrongdoer. *Id.* "Restitution serves to 'deprive the defendant of benefits that in equity and good conscience he ought not to keep, even though he may have received those benefits honestly in the first instance, and even though the plaintiff may have suffered no demonstrable losses.'" *Id.* at 1063. *Schock v. Nash*, 732 A.2d 217, 232-33 (Del. 1999) (footnotes omitted; citations supplied).

576. *Scrushy v. Tucker*, 955 So.2d 988, 1012 (Ala. 2006).

577. *Id.* at 1004.

578. *Id.*

579. *Id.* at 1012.

580. *Id.* at 1007.

581. *Id.* at 1008-09.

582. *Id.* at 1008.

583. *Id.* at 1008-09.

584. *Id.* at 1012.

585. *Id.* at 1011 (quoting *In Re HealthSouth Shareholders Litig.*, 845 A.2d 1096, 1106 (Del. Ch. 2003)).

586. *Id.* at 1012.

IV. CONCLUDING THOUGHTS

This article has presented the legal foundations and theories parties will encounter when dealing with executive compensation litigation. Several aspects of executive compensation law are favorable for plaintiffs, such as the 34 Act or the federal Bankruptcy Code. However, defense counsel may find a more favorable litigation environment for their clients under Delaware State law. Both sides, however, will have to consider and address the impact of new regulation such as TARP. The ongoing economic crisis has created an antagonistic political and social energy that will continue to shape the executive compensation issue for all actors involved. This article should serve as a suitable starting point for practitioners litigating executive compensation issues in the years to come.

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